

**BRIDGING THE EQUITY GAP: EXAMINING THE
ACCESS TO CAPITAL FOR ENTREPRENEURS
ACT OF 2006**

HEARING

BEFORE THE

**COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES**

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BRIDGING THE EQUITY GAP: EXAMINING THE ACCESS TO CAPITAL FOR ENTREPRENEURS ACT OF 2006

WEDNESDAY, MAY 10, 2006

HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
Washington, DC

The Committee met, pursuant to call, at 2:13 p.m., in Room 2360, Rayburn House Office Building, Hon. Donald A. Manzullo [Chairman of the Committee] Presiding.

Present: Representatives Manzullo, Kelly, Chabot, Akin, Poe, Velazquez, Udall, Christensen, Barrow and Moore.

The CHAIRMAN. Good afternoon, and welcome to this important hearing.

On April 26, 2006, I introduced H.R. 5198, the Access to Capital for Entrepreneurs Act of 2006, or the ACE Act, with Representative Earl Pomeroy, our colleague from North Dakota. This bipartisan measure provides a mechanism for our nation's small businesses to obtain critical equity funding. It does so by establishing a tax credit for the individuals and partnerships most likely to provide equity funding to small early stage companies. The purpose of this hearing is to examine and discuss the angel investor market and its potential effects on small businesses through the implementation of the ACE Act.

This Act was patterned after successful programs in 21 States, 11 of which have representation on this Committee. These States include: Arizona, Colorado, Hawaii, Indiana, Iowa, Maine, Michigan, Missouri, New York, Ohio, and Wisconsin.

Where is Illinois?

These State tax credits have materially helped increase the amount of early and emerging company financing being provided to our Nation's small businesses. Today, a government official from Wisconsin is going to provide information on how the Wisconsin State tax incentive is working.

The ACE Act provides a needed boost to our nation's qualified small businesses by helping angel investors increase equity stakes in these companies. If the provisions of the ACE Act were signed into law, many small businesses which would otherwise fail for lack of adequate resources could grow and expand, creating more jobs for Americans. The United Kingdom already has a similar tax program in place that encourages new investments in emerging and early stage companies. The UK's incentive has proved extremely popular and resulted in the influx of tremendous amounts

of capital. We want to provide the same type of incentive to the growing and emerging small businesses in our own Nation.

I now yield to the ranking minority member, Representative Velazquez of New York, for her opening comments.

[Chairman Manzullo's opening statement may be found in the appendix.]

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Access to capital is the key to success for many small businesses, but in today's economy this is easier said than done. Many entrepreneurs need all the help they can get in securing the capital needed to start and run their businesses. Venture capital has long filled this role by putting seed capital directly into the hands of small business start-ups. Unfortunately, this source of financing is simply not accessible to many entrepreneurs starting out today, particularly women and minorities.

This is why initiatives such as the Small Business Investment Company, SBIC, are so important in filling this gap. This program has a proven record, making an average investment per business of around \$1.1 million, serving as a critical source of capital for early stage businesses. Now that the SBIC participating securities program has been shut down for over a year, with no plans for re-opening, the need for such a government initiative has become more important than ever.

As we will hear today, angel investors are working to fill this role. A lesser known and less formal alternative to traditional venture capital, angel investing is truly the wave of the future for thousands of small business start-ups across the country. Last year alone, there were 225,000 active angel investors in the U.S. who invested \$23 billion in small businesses by focusing directly on early stage and growing entrepreneurial ventures that have faced difficulty in securing equity financing.

This is the avenue for getting much-needed capital into the hands of our Nation's small businesses. These entrepreneurs are some of the most innovative out there, and these are the types of high-risk, high-reward investments that will pay off in the long run. The question is: How do we make angel investing a valuable source of financing for this Nation's entrepreneurs?

Clearly, the obvious first step is providing tax credit incentives for angel investments in qualified small businesses. Investment tax credits for equity funding provides a good incentive to spur this investment in small firms.

This is an important step in nurturing local companies with increased early-stage financing, but on its own tax credits are simply not enough. We need to make sure that the SBA is involved in this process. As the only agency tasked with assisting this Nation's entrepreneurs, it is the SBA that truly understands the challenges small businesses face, has experience in helping business owners, and knows the importance of involvement at the local level.

This bill and support system will provide both small businesses and investors alike with good, reliable advice, a system that will go a long way in spreading angel investment to companies across the country.

We also need to commit more to assist women and minority-owned businesses, sectors that have traditionally faced difficulty in

accessing equity financing. These companies have the potential to infuse innovative new ideas into the economy, which makes angel financing a good investment. It is clear that they need these investments as well, and angel funding must be a valuable source of financing for the next generation of women and minority entrepreneurs.

Clearly, angel financing is of vital importance to small businesses. As the economy continues to rely on entrepreneurs to spur job growth and stimulate economic development, the need for such an initiative only grows. In that respect, we need to consider a variety of proposals in an effort to provide the best investment for our Nation's businesses and the future of our economy.

Thank you, Mr. Chairman.

[Ranking Member Velazquez's opening statement may be found in the appendix.]

The CHAIRMAN. Thank you.

The rules are that you limit your testimony to 5 minutes. Your complete written statements will be made a part of the record. We will keep open the record for 2 weeks for anybody that wants to add additional testimony. It is limited to two typewritten pages, and the smallest type print is 10 point, okay? No books or anything like that appended at the taxpayers' expense.

When you see the yellow light, that means that you have one minute. When you see the red light, that means wrap up in a hurry.

The CHAIRMAN. We are going to lead off with a last-minute addition. My cosponsor of the bill is Earl Pomeroy from North Dakota; and, Earl, as soon as you feel comfortable—obviously, you can leave the panel to get back to your congressional duties—but we look forward to your testimony and statement.

STATEMENT OF THE HONORABLE EARL POMEROY (ND-AT LARGE), U.S. HOUSE OF REPRESENTATIVES

Mr. POMEROY. Thank you, Mr. Chairman.

The opening statements of you and the ranking member reflect once again the Small Business Committee is one place where often we see some rare but wonderful glimpses of bipartisanship as Republicans and Democrats across the aisle try to answer the real problems facing growing our economy.

Certainly in the small business area, Congresswoman Velazquez has it exactly right: Access to capital continues to be and will always be one of the most significant hurdles in growing and developing new opportunities through the small business sector.

It has come to my attention that the opportunity to seek equity funding, especially from venture capital funds, has diminished as these funds have gravitated towards larger, more established businesses, driven by a number of factors, including the higher risk of the smaller, newer start-ups.

I look at the ACE Act, the investment tax credit copied after State initiatives which have long been in place in this area. North Dakota's effort, for example, was initially passed in 1989 and has been extended and improved several times. That is the value we believe this has back home, is a model that I think will help incent capital in this way; and it will, in my opinion, offer a balance to

the higher-risk premium that capital is going to take as they go down to this level of what is known as angel investing.

We have at the University of North Dakota the Center For Innovation, led by Bruce Gjovig. He was instrumentally involved in the creation of this legislation.

I do commend you, Mr. Chairman, for the vetting that this proposal has had in terms of trying to make certain that we have developed a proposal that wasn't just good in spirit but that actually works; again, has been closely copied by that which has already been marketed and tested at the State level. Those of us with experience in local and State government truly do believe that that is where the laboratories of innovation for our country are. In my opinion, the lab results are in. It is time now to federally move to an even greater incentive that the Federal Tax Code could represent and offer the ACE Act.

These comments are extended on in my testimony, but the real experts are with us, so I want to keep my remarks short and move to the other panel members, Mr. Chairman. I would be happy to take any questions before I have to leave to get back to my other Committee, but I do want to thank my fellow panel members for their leadership in this area and helping us understand the critical role of angel capital.

The CHAIRMAN. The Chair thanks the gentleman from North Dakota very much. We appreciate your testimony.

[Congressman Pomeroy's testimony may be found in the appendix.]

The CHAIRMAN. Our next witness is Susan Preston. She comes all the way from Seattle, Washington. A microbiologist by trade and also an attorney. We look forward to your testimony.

STATEMENT OF SUSAN PRESTON, DAVIS WRIGHT TREMAINE LLP

Ms. PRESTON. Thank you very much.

Chairman Manzullo, Ranking Member Velazquez, and members of the Committee, thank you for inviting me here today to testify before this Committee on bridging the equity gap and examining the Access to Capital for Entrepreneurs Act, or ACE Act.

I am testifying before you as an expert in the field of angel financing and the funding gap and, in fact, testified before this Committee in April of 2005 as such an expert with regard to SBA's defunding of the SBIC program.

Just to remind you and give you context to my testimony and highlight my background, I am considered a national and international expert on angel and private equity financing. I have lectured, conducted workshops, written articles, white papers, consulted with various government and NGO organizations on the topic in close to 100 different settings to date.

I am the founder of an angel organization in Seattle called Seraph Capital Forum, the first all-women's angel organization in the United States.

I have a well-written and well-received book on angel organizations that is being used in a number of different locations nationally and internationally on establishing angel organizations; and I

am currently writing a book, an entrepreneurship guide to angel financing, under contract with Wiley Publishing.

I am also a founding member of Angel Capital Association and a continuing board member for the successor Angel Capital Education Foundation.

I am an entrepreneur-in-residence with the Kauffman Foundation and have been, for the last 6 years, focusing my attention entirely on angel financing. I am one of four lead instructors for the Power of Angel investing program that Kauffman puts on.

About 6 months ago, I approached staff on the House Committee with the idea of an income tax credit for private equity financing, in part as a response to the chairman's request for ideas to fill the ever-expanding fund gap, which had been partially filled by the now defunded SBIC program. Over these months, I have worked with staff on my own time as an individual citizen to develop what is now currently the ACE Act.

Considerable work went through and into the development of ACE, including the establishment of a working group of experts in private equity financing and representation from national organizations, as well as representation from the States that currently have income tax credits, a total of 21 States.

The roundtable discussions with this working group were highly informative and valuable in defining many critical structure aspects for ACE. ACE now represents what we consider the best of State programs and benefits from the lessons learned by these States in development and implementation of their own programs. The result is a considerable effort in time and thought-out program into the ACE Act.

It is simplistic, self-executing; and that is part of the beauty of it as a Federal income tax credit for early stage investors. It represents and gives opportunities both to individual angels as well as to partnerships or angel funds, and it also provides that well-needed—as the chairman and ranking member have pointed out, that well-needed fund for those young companies and growing companies in that area.

The initial responses from the angel community have been extremely enthusiastic for the bill as it targets exactly where their interests are in several aspects. As mentioned and as has been put into the record, this is a very important aspect of funding, between the friends and family round of small amounts for companies just starting and the venture capital rounds.

Venture capital is, on average, an investment of \$6 million to \$7 million per deal, far above what a young company needs from the standpoint of early investing. Therefore, with only 3.3 percent of venture dollars going into seed and early stage, we clearly need another area of investment. Angels fill that and have been filling that to a certain extent with 55 percent of their \$23.1 billion going into seed and early stage. In fact, they invested in nearly 50,000 deals in 2005, which is an average of a little under \$.5 million per deal, a very good and interesting spot for funding for these early stage companies.

Moreover, angels are being asked to invest in second and third rounds of financing because of the absence of VC funding and also the lack of need sometimes of entrepreneurs for large-scale VC

funding. Therefore, again, angel investors provide that critical and essential part of a healthy economy.

The attributes of this bill are, I think, self-evident in its independence, allowing lone-ranger angels to invest rather than through angel funds and providing both for the individual angel as well as for the angel groups. It allows the angels to remain anonymous. It allows for some reduction of risk at a high-risk investment time period for them and allows them to choose their own investment at their own time period, as angels prefer to do.

It addresses these critical attributes, and I believe that it is a well-defined and well-structured tax credit providing those needed incentives to angel investing.

Thank you.

The CHAIRMAN. Thank you. I like this jargon. Lone-ranger angels. It is interesting.

[Ms. Preston's testimony may be found in the appendix.]

The CHAIRMAN. Our next witness, Dr. Ian Sobieski, is an aeronautical engineer and founder and managing director of Band of Angels, which sounds like a motorcycle club, in Menlo Park, California. And I notice that you graduated from Virginia Tech with a double major in aerospace engineering and philosophy. That is a good mix.

Mr. SOBIESKI. Well, thanks.

The CHAIRMAN. Good mix. We look forward to your testimony.

STATEMENT OF IAN SOBIESKI, PH.D., BAND OF ANGELS

Mr. SOBIESKI. Thank you, sir.

Chairman Manzullo, Ranking Member Velazquez, members of the Committee, it is a pleasure to be with you here today. As you said in your kind introduction, I come from neighboring Virginia, and it is nice to be back in my old neck of the woods once again.

Since 1997, I have been privileged to help run an organization called Band of Angels in Silicon Valley, California. This organization of angel investors, like many, is made up of SEC-accredited investors who have an interest in investing their time and their money in new young start-ups.

What sets the Band apart is that an additional requirement for membership in our organization is that the angel has to have actually been an entrepreneur or a senior officer in a high-technology company. So members of our organization include the founders of Logitech, Symantec, National Semiconductor, the former CEO of Hewlett-Packard, the former CFO of Intuit, the former VP of Marketing for Intel, and a slew of other C-level executives from important companies that are less well-known than these.

These are people whose average age is in their late 50s; and they have reached a point in their lives where, as I like to say, they want to stay in the game but not stay up till 2 a.m. Any more. As important as their capital is to the company, what is more than important to many of these entrepreneurs is the mentorship they provide, the guidance on how to build their business, as they did early in their careers, from nothing to something.

Since its inception in 1994, the Band has invested in more than 180 start-up companies. Of those, nine ended up going public; and that is quite a feat. We are talking about nine companies that we

seeded with the first money eventually going public on the NASDAQ. Thirty-three more were acquired for a profit to the investors and, of course, to the founders. And it is worth noting that 60 have failed, completely bankrupt, for a complete loss.

But win, lose, or draw, every company that the Band seeded allowed an innovation to occur, allowed jobs to be created, and allowed an entrepreneur to pursue his dream. In total, we estimate something like 3,500 jobs have been created by companies that were seeded by the Band of Angels; and this story is copied over and over again across the country, both in formalized angel groups, in small networks of angels, and individual angels acting on their own.

It has been mentioned here before and it seems to be an accepted fact that venture capital can't service the entrepreneurial marketplace, and it really is the case that venture capital gets far too much credit as the font of innovation in this country. It is the latest development in the financial food chain, the financial structure that has been developing over the entire history of this country to more cleverly and efficiently deploy capital earlier and earlier in the whole life cycle of a company.

But venture capital, as Sue just mentioned, is really structured to deploy several million dollars per company. The partnerships are limited to 10-year lives. Their entire structure requires liquidity in that period of time and needs the kind of return multiple that many companies simply are never going to produce, companies that are still valuable both to society and to the entrepreneurs. This is where angels have always fit in. They have always provided that critical capital to these companies.

So that is where these bills that we are considering here today could play such an important value. If you imagine the life-cycle of all the companies in the marketplace as a funnel, with the biggest end of the funnel being the seed stage, narrowing down to the Googles of the world, those very few exceptional companies that change the entire order of magnitude of things, angels play at that seed stage.

Currently, there simply is not enough capital and not enough resources to supply the constellation of companies that can and would provide innovation. The tax credits that we are considering here today would essentially add fuel to the furnace of innovation. You know, if you have gasoline in a tank, you can heat it very hot and it won't catch fire. What you need is oxygen. What we are talking about here is increasing the flow of oxygen to a part of the food chain that is deprived of enough to create as much innovation as we would like.

If we do this, I am not saying that all these companies will be successful. All of them won't necessarily be the next Google. In fact, there might be more money losers. But the bottom line is: Win, lose, or draw, these kinds of tax credits will create more start-up companies. More failures but more successes. Which ones? We don't know. But if you pass a version of this kind of proposal, I'm confident that I can guarantee that you will help create another Google, another Apple, another Microsoft, another Sysco.

Thank you very much. We look forward to your questions.

The CHAIRMAN. Thank you.

[Dr. Sobieski's testimony may be found in the appendix.]

The CHAIRMAN. Our next witness is from Wisconsin, and Congresswoman Moore will be introducing her. But, before that, the witness has already forgiven me for attending Marquette University. A little bit of a rivalry there between the University of Wisconsin and Marquette University.

Ms. Moore.

Ms. MOORE. Well, thank you so much, Mr. Chair, for this privilege—although I am a Marquette grad—for this privilege to introduce a native daughter of Wisconsin. We are so proud of our Secretary of Financial Institutions in Wisconsin.

She has really been doing this—she is an expert and has been doing this for a long time. She has over 18 years experience in the banking and securities industry in Wisconsin and has done a variety of things, including helping municipalities and municipal treasurers with their mutual funds and managing corporate accounts.

Prior to having been appointed as Secretary of Financial Institutions, she was the adviser to Virchow Krause, which is the third largest accounting firm in the United States, to ensure their compliance with ERISA.

She is a scrapper. She was born in central Wisconsin, Thorp, where she was the youngest of 12 kids. So that is a story of survival.

She does it all well. She is married to Jack; and she has four daughters, Catherine, Sarah, Margaret, and Alexandra. So I know that that is a challenge keeping up with her jewelry and her perfume. I know the story, trust me.

She is very active in a variety of non-profit organizations Statewide, a very responsible and well-balanced citizen; and it is with such great pride that I introduce Secretary Lorrie Keating Heinemann.

Welcome.

The CHAIRMAN. Sounds like a nomination speech.

**STATEMENT OF SECRETARY LORRIE KEATING HEINEMANN,
WISCONSIN DEPARTMENT OF FINANCIAL INSTITUTIONS, DE-
PARTMENT OF FINANCIAL INSTITUTIONS**

Ms. HEINEMANN. Well, thank you. I have got to tell you, I was not expecting that. I am very honored, Congresswoman Moore.

As many of you know, Congresswoman Moore was the author and one of the main instigators of Act 255, which is our tax credit package in the State of Wisconsin, and I am here to talk today a little bit about the success of that program that she put into place and what we have achieved. So certainly thank you, Mr. Chairman, for the opportunity here to testify.

The Department of Financial Institutions, many people probably may not have heard of that. But what we do is we primarily regulate banking, security, credit unions; and then we are also the corporate filing agent for about a quarter of a million corporations in the State of Wisconsin. However, under Governor Jim Doyle's Grow Wisconsin Plan, he also indicated he wanted us to focus on economic development; and this is my role as the Department of Financial Institutions Secretary, is working with the other departments throughout the State.

In 2003, Wisconsin Act 255 was put into place. It is a 25 percent tax credit for angel investors and seed funds, also for their investments in qualified new business ventures in the State of Wisconsin. It went into effect January 1st of 2005. Since that time, we have achieved significant results. There were \$3 million of total angel tax credits available in 2005. All of the credits were used. Over 290 individual angel investors participated. Over 40 companies were funded. The total amount of measurable angel investing was \$19.5 million.

By measurable, I mean we actually have the company names, the investors, and we have avoided duplication. But we do believe that the total angel investing, which is more through the data that we got through our attorneys, is about \$50 million in the State. So it is a very, very important function of growing businesses in the State of Wisconsin.

I had the honor to help cofound a Statewide angel network called the Wisconsin Angel Network; and we provide education, networking, and deal flow to the angel networks in the State.

I have to take just a moment to thank Sue Preston. She did come into the State of Wisconsin a couple of years ago, when Act 255 was just going into play; and we were able to significantly increase the amount of organized angel networks in our State. We had six at that time. We now have 15. Again, very important to bring and partner with Kauffman Foundation in educating and making sure that the angels in our State are very comfortable with the process.

Just to give you a couple of examples. eMetagen Corporation is a company that was funded by the Golden Angels Network, and this was as a result of Act 255. They did take advantage of that credit. Up to 10 jobs will be created over the next 12 months. It is a very high-tech company that was seeded actually with the Wisconsin Alumni Research Foundation, which is at UW Madison.

Also, another company you may be interested in that was just funded, Mithridion, a \$1.6 million angel round, is currently in the process of establishing its lab at the University of Wisconsin Research Park.

So if I were you, in your position, I would say, well, why is a tax credit package good for government economic policy? Well, first, I think it encourages the private sector to invest in the American economy. Second, I think it provides an increased availability of capital, that access to capital that Ms. Velazquez was talking about; and it attracts high-tech, high-growth entrepreneurial companies because this is what angel investors invest in.

Yesterday, I had the honor of joining the Phenomenal Angels, which is a new fund that just announced yesterday they have raised several million dollars and they are focusing on investing in women and minority-owned businesses in the State of Wisconsin. So we are thrilled to have them on board.

Finally, it puts a positive focus on our economy. As many of you know, the U.S. is a leader in angel and venture investing; and this tax credit package I believe is a win-win proposal. It leverages private investments at a very low cost to the government.

So, again, thank you for the opportunity to testify in support of H.R. 5198.

[Ms. Heinemann's testimony may be found in the appendix.]

The CHAIRMAN. Our next witness, is it Loague?

Mr. LOAGUE. Loague. That is correct.

The CHAIRMAN. Dan Loague is from Reston, Virginia. Mr. Loague is Executive Director of Capital Formation Institute. He has a very interesting background, working in China; and I notice that you worked on electronic reconnaissance systems on the RF4C Mach 2 aircraft in your tenure in the Air Force.

Mr. LOAGUE. That is right.

The CHAIRMAN. It is just fascinating to see the educational backgrounds of the folks here. I am delighted that there are no economists, because a band of ill-advised economists just raised the interest rate again for the 16th time. Here we are trying to create more capital, and those clowns are out there making capital harder to get.

They believe that if they decrease the money supply, people will buy less fuel, because it is petroleum that is causing the bit of increase in inflation. The problem is that people are charging fuel on their credit cards because they do not have enough money to pay it at the gas stations, and they are just increasing the amount of inflation themselves.

So I just love to be around real people and not have the economists come in here and tell us how to run our world.

Mr. Loague, we look forward to your testimony.

STATEMENT OF DAN LOAGUE, CAPITAL FORMATION INSTITUTE

Mr. LOAGUE. Thank you very much, Chairman Manzullo, and my thanks also to Representative Pomeroy and Ranking Member Velazquez. Thanks for holding this hearing today.

The Access to Capital for Entrepreneurs Act of 2006 is an exciting opportunity to expand seed-stage capital for start-up and growing U.S. companies. This is a remarkable piece of legislation. It is an impeccable match with the practices of angels and seed-stage fund investors; and it also targets seed capital, the most important and continuously unfulfilled need of start-up companies.

Let me talk a little about Capital Formation Institute and the National Association of Seed and Venture Funds. I am now the Executive Director of the Capital Formation Institute, formerly Executive Director of NASVF.

CFI is an independent 501(c)(3) spin-off of the NASVF. The NASVF, I think, after working some dozen or so years with seed and early-stage investors, is now the largest network of seed stage and technology investment professionals.

Now, both these organizations are concerned with expanding capital for start-up in high-growth companies. But, unfortunately, outside of these organizations, when you get beyond these organizations, the whole business, this part of the market, is under the radar and largely unknown. I get up in the morning and I think to myself, this is old stuff. But when you start talking to people, they are just simply not aware of it. They do not know what it is, and it is significant.

Dr. Jeffrey Sohl, the Director of the Center for Venture Research at the University of New Hampshire, the leading researcher in this area, who has done research for years now, has said that, year

after year, since the '90s, that the angel investing market component has either exceeded or matched all of the combined VC investments in seed-stage companies. And more importantly than that, whereas you will see the VC companies investing in a few hundred start-ups, the angels will invest in tens of thousands and, as Sue has said, up to 50,000 companies per year. This is the driver of an innovative economy, and it is the heart of our competitive economy.

When I was with the NASVF, I did about 100 events that were invitation only, which means I had to research who were the best people to come to participate in a peer-to-peer environment. So over about 9 years I got to know some of the really, really great people in this area, and a lot of them are seated at the table right now. I am happy to see them again.

So when I heard about the Committee hearing last week, I contacted eight people around the country and asked them what they thought would be the effect of the Act's passage, and I hope I can get through all eight here, but I will go ahead and try.

The first person I talked to was a gentleman by the name of Steve Mercil, with RAIN Source Capital in St. Paul, Minnesota. RAIN Source is a multistate network of angel investors. It is an incredible operation, and Lorrie is familiar with that.

What Steve told me was that the benefits—and here I am kind of summarizing, but I don't want to get into the details—the benefits of the Act are beyond the tax credit. It raises the importance of investing in entrepreneurs. With the Act, we expect a 50 percent higher number of investors in our funds and 50 percent more dollars in our angel investment pools; and, more importantly, raising the funds will be quicker. The tax credit could be the last little push needed.

Then I went to Burt Chojnowski, with Brain Belt Consulting in Fairfield, Iowa. Burt's part of a rural miracle in Fairfield, Iowa. That is a wonderful town. You ought to check that one out. He is an active proponent of enterprise development in rural areas; and he said, quote, "This is fantastic. It parallels what the Iowa Capital Investment Board has done with State tax credits and would be a real boon for angels and a community seed fund."

Orlan Johnson, with the Tri-State Investment Group in Research Triangle Park, North Carolina—TIG it is called—is one of the most successful angel groups in the U.S. besides the Tech Coast Angels. And he said, "It sounds similar to the North Carolina situation, which I would say works, but I am biased because I participate in the credits. There is a significant leverage generated for the State for this kind of tax credit program. It has been a factor in getting people that may not have taken the risk into the early-stage game. At 25 percent, it is substantial enough to get wealthy individuals to at least take a look at this investment class as an option for their portfolio."

Woodrow Maggard, with UB-STOR in Amherst, New York, is building the New York tech-based economy and says, "It would facilitate stronger angel networks and help bridge deals that now flow into early-stage capital."

Liz Marchi at Montana West Economic Development in Kalispel, Montana. Thanks to Ms. Marchi, Kalispel now has an angel group; and she says, "You know, we need to be driving innovation capital

in all parts of the country, and our group believes this is a way that the private sector can contribute it in a needed and positive way to the local economy. Having the Federal Government realize that this is essential to competitiveness would be very, very nice."

The CHAIRMAN. One thing I cannot reinvent is the clock.

Mr. LOAGUE. Okay, sorry. Let me just mention the three last people on the list. I won't quote them.

But Larry Peterson, with Camino Real Angels, El Paso; Robert Mitchell, Alpha Omega Capital Partners, Richmond, Virginia; and Barry Moltz, with the Prairie Angels. And what Barry said was, "How Can this be a bad thing?"

Thank you.

The CHAIRMAN. Thank you very much.

[Mr. Loague's testimony may be found in the appendix.]

The CHAIRMAN. Our next witness is Luis Villalobos, the founder of Tech Coast Angels. I just love the names of these organizations. He has handled 108 portfolio companies and received nearly \$724 million in capital.

Mr. Villalobos, we look forward to your testimony.

STATEMENT OF LUIS VILLALOBOS, TECH COAST ANGELS

Mr. VILLALOBOS. Thank you.

Chairman Manzullo, Ranking Member Velazquez, and members of the Committee, I thank you for the opportunity to testify. I am Luis Villalobos, testifying as an individual.

My entire career has been involved with small companies as an entrepreneur and as an angel. I was founding CEO of two start-ups. When we sold them, their revenues exceeded \$80 million and had created hundreds of jobs. Over a 25-year period, I have personally invested \$3.5 million of my personal capital in 57 small companies. To date, their returns are nearly five times my investment; and they have created more than a thousand jobs.

I started Tech Coast Angels in Southern California, and now it is the largest angel group in the country. I ran TCA for the first 2 years and continue to be very active. In 8 years, we have funded 108 small companies with \$68 million of member capital and attracted another \$656 million from external capital, mostly VCs. These 108 companies have created over a thousand jobs.

I was one of nine founders of the Angel Capital Association, and I conduct workshops for angel group leaders. My undergraduate degree is from MIT, my MBA from Harvard, and I was a National Merit Scholar. I am in the course of raising a VC fund to coinvest with angel groups.

I would like to make five quick observations:

First, only a tiny fraction of small companies are what GEM calls high-expectation entrepreneurs, but they create the preponderance of jobs and wealth and economic growth.

Second, that is where the severe funding gap is, for these high-expectation entrepreneurs.

Third, investing in early stage ventures is extremely challenging. Fortunately, we know what succeeds: Active investors who use a professional investing process and who have extensive networks to support the companies they fund.

Fourth, the emergence of angel groups offers a robust model for early-stage investing.

And, finally, about 10 million individuals annually invest around \$100 billion into entrepreneurial companies. Nine million of them each invest less than \$20,000 per year, but only about 10,000 of the 10 million individuals are in angel groups. There is no consensus on a definition for angel investors and almost no data.

Some comments on the bills:

I can and do support both bills. However, if I had to choose between tax credits, I would favor the one in H.R. 4565 because it more narrowly targets small business and because it should be more capital efficient by putting the credits in the hands of presumptively successful investors.

I believe the proposed angel finance program is excellent, though I would like some changes. The recycling of profits is commendable.

I also support the grant program for development of angel groups and the establishment of an Office of Angel Investing.

The Federal Angel Network may need an intermediary, for example, angel groups, between the entrepreneurs and the individual investors. That is a lesson we learned in ACE-Net.

Five recommendations:

First, focus on closing the funding gap for what GEM calls the high-expectation entrepreneurs, the companies that create the most jobs and economic growth.

Second, focus on investors who meet the success profile: Active, have professional investing processes, and have broad networks.

Third, provide support for existing angel groups and to develop new ones.

Fourth, support the Department of Commerce's group on venture capital. And what they recommended was to combine the activities of angels who are active in seed and early stage investing with mainstream venture capital through some form of coinvestment models.

Finally, collect statistics on the 10 million individuals that GEM calls informal investors and on angel investors.

I am grateful to this Committee for holding this hearing and for the opportunity to testify. I welcome your questions. Thank you.

The CHAIRMAN. Well, thank you very much.

[Mr. Villalobos' testimony may be found in the appendix.]

The CHAIRMAN. What I would like to do is for Secretary Heinemann to walk me through a transaction, perhaps one that you were involved in, where you would see a benefit to an angel network.

Ms. HEINEMANN. Well, I was not involved in any particular transaction, but I can certainly give you examples of transactions that have occurred in the State of Wisconsin.

The CHAIRMAN. That would be fine.

Ms. HEINEMANN. Okay. We developed an organization called the Wisconsin Angel Network, and it is a network for angel networks in the State. We provide services. One of those services is networking and deal flow.

The largest angel network at the time in 2004 in our State was the Golden Angels Network, which is out of Marquette University. It had about 150 members, a good regional, very active angel net-

work. Had never set foot on the University of Wisconsin Madison's Research Park. Had never set foot.

The CHAIRMAN. We know why, don't we, Ms. Moore? Something to do with basketball, I think.

Ms. HEINEMANN. The reason I mention that to you is because, through the Wisconsin Angel Network, which came out of the Act 255 tax package that Congresswoman Moore was so instrumental in, we were able to create this Wisconsin Angel Network, and we started talking about tax and angel investing in our State. This network came over and met with eMetagen Corporation. eMetagen helped them package a \$535,000 seed round through the Golden Angel Network, and that is what created the 10 jobs at the research facility in Madison—additional jobs, actually, throughout the United States and New Jersey.

So that particular transaction became a certified company, as a qualified new business venture, under Act 255. That put it on the radar screen along with the Wisconsin Angel Network. That made the connection to the Golden Angels Network, which then they turned around and invested in the deal and the business was created and the money was able to create those jobs.

So that is kind of the A to Z: The tax credit package went into place, the network came out of it, the company became certified, the certification attracted the angels, the angels invested, and now the company is up and running with ten new jobs.

The CHAIRMAN. I have a question here for Mr. Villalobos. The term "high-expectation entrepreneurs."

Mr. VILLALOBOS. Yes, sir. There is an organization that puts out—it is a combination of Babson in Boston and the London School of Business. It used to be Kauffman that was their primary sponsor. They put an annual report out on global entrepreneurship, and they have a section on the U.S. Last year, for the first time, they put out a specific report on what they called high-expectation entrepreneurs, the ones that create the job growth.

I can certainly submit a copy for the record, if the chairman would like.

The CHAIRMAN. We don't want to attach that book to the record. Is that a book that you want to put in?

Mr. VILLALOBOS. No, no, it is their report.

The CHAIRMAN. A report? That would be fine. We will have to use an executive summary for that. Is there one in there?

Mr. VILLALOBOS. I am sure there is.

Mr. VILLALOBOS. But, anyway, that is their term for it. There are lots of other terms.

The CHAIRMAN. Are these the entrepreneurs that have given themselves that name?

Mr. VILLALOBOS. No, it is what they gave them. Because what they found is, of the huge number of small companies, a tiny fraction of them are the ones that—and that is where it came from. They did a survey and said, "Do you expect to have created 20 jobs or more in 5 years, or 50 jobs or more in 5 years?" and if their expectations met that, they fell in the high-expectation category. And it was those that create the jobs.

Now, they are a tiny fraction of all the start-ups.

The CHAIRMAN. Really?

Mr. VILLALOBOS. Yes.

The CHAIRMAN. So it is a self test?

Mr. VILLALOBOS. It is a self test that says, when you are starting this business, are you expecting to create at least 20 jobs within 5 years.

The CHAIRMAN. And a tiny fraction only say yes to that?

Mr. VILLALOBOS. Correct. Keep in mind that the SBA definition of small business encompasses 99.7 percent of all companies in the U.S. So it covers everything. Most of our little companies—and they are great, and I am not saying we shouldn't support them. But they are the ones that started the little neighborhood barber-shop and corner grocery store, et cetera. They are not the ones that take off and eventually become our Googles and MicroSofts and Home Depots and Federal Express.

The CHAIRMAN. My dad had a corner grocery store, and he had a restaurant, so I can relate to that.

Ms. Velazquez.

Ms. VELAZQUEZ. Mr. Villalobos, judging by your experience, you appear to be an expert in angel groups.

Mr. VILLALOBOS. Correct.

Ms. VELAZQUEZ. Obviously, you have concluded that such groups are effective in soliciting projects and then analyzing and funding angel investments. Can you tell us about that and about the importance of the government helping to stimulate such groups and such interest?

Mr. VILLALOBOS. Sure. What I like to do before I get into something is to really study it first. I had already been an angel investor as an individual, and I was approached by our business counsel locally on a pro bono basis to stimulate Orange County economy.

I talked to, in fact, the founder of the Band of Angels, Hans Severiens, who effectively helped me think through the idea of the angel group; and I modeled it after the Band of Angels and added some process. But, at the same time, I read a Federal Reserve report; and they analyzed in detail why venture capital funds succeeded. And the reasons that they found were really two, on the operational side, what they called alignment and a process. Alignment simply being whoever is responsible for making the investment decision should have either their capital at risk or their compensation at risk. If you do that, that is one key element of success; and the other was having a professional investment process.

What I found with the Tech Coast Angels is when you have—and Ian can probably tell you the same thing. When you have a group of 25 CEOs, former CEOs, sitting in a room talking to a company and analyzing what they are doing or coaching them across the whole process, you need both that critical mass of 20, 25 minimum, and you need that diversity of expertise. That really ameliorates the risk.

So if you want to put capital into that segment and reduce the risk and increase the capital efficiency, I think an angel group is an excellent way to do it.

Ms. VELAZQUEZ. My second question to you is, why do you think it is so important that we target the investment into small high-growth companies?

Ms. KEATING HEINEMANN. If the goal is to create jobs in economic growth, that is where you are going to get it. I think you will find statistics from lots of places that will show consistently that that is what creates jobs. That is not to say that the other small companies don't because it is—it is, you know, where you have a fraction of maybe a percent or 1 percent may create a huge amount of jobs, but then when you have got, you know, the big numbers that each incrementally, it is like an army of ants.

So both are very useful to our economy; but if you are interested in focussed capital to create lots of jobs, that is where it should go.

Ms. VELAZQUEZ. Thank you. Ms. Keating, you mentioned creating a team between the State government and the Wisconsin Technology Network that created a mechanism that provides education and networking assistance. How important do you think such a government partnership is to the success of your program? And would you recommend that any angel bill this committee moves forward to take into consideration, this kind of public/private partnership tools?

Ms. KEATING HEINEMANN. Thank you. That is a great question. I will say one of the first things we did, our governor was facing a \$3 billion deficit when he took office in 2003, and our focus was, how could we leverage the private investments at the minimum cost to the government and really spirit the economy? So the first thing we did was we went out, and we looked to see what was out there, and we found the Kauffman Foundation was starting the Angel Capital Association, and they provided us tremendous tools and expertise and came into our State, taught us about angel investing, helped us start the networks. We felt it was very important not to duplicate the efforts that were already occurring in the private sector. And so the Wisconsin Technology Council is who we partnered with the State of Wisconsin, and we felt very strongly an angel-led program should not be in a State agency because they had tried it, and it didn't work because angel investors are very private people.

They want to invest their own money and it is really no one else's business. But they are willing to provide data to us in an aggregate form and that is why we created the Wisconsin Angel Network. And we purposely funded it outside of the State agencies, Commerce and the Department of Financial Institutions gave a grant to the Wisconsin Technology Council to run the Wisconsin Angel Network, and the State agencies are not involved in the day-to-day operations, but the governor, the cabinet, the commerce, my department, we all highly encourage angel investing in our State, and we try to educate people on the tax credits that are available.

Ms. VELAZQUEZ. I don't think the question implies that the program will be run by the government, but that is healthy to have that type of public/private partnership.

Ms. KEATING HEINEMANN. Oh, absolutely. I would agree.

Ms. VELAZQUEZ. You know, we have, under SBA, the private loan programs. They are created by the SBA, but it is run by the private industry. It is a private/public partnership. One of the best we have.

Ms. KEATING HEINEMANN. Our SBA in Wisconsin is fabulous. So I would agree with that. It does great job partnering with our banks and our investors.

Chairman MANZULLO. Ms. Moore.

Ms. MOORE. Thank you so much, Mr. Chairman and ranking member. I want to welcome you all again, and it has really been a very interesting having you here. I guess I want to put this question to our Secretary of Financial Institutions from Wisconsin. Any of the others that would like to chime in would be welcome to do it.

One of the reasons why I was so excited about engaging in venture capital development in Wisconsin is because literally, the area that I represented in the State senate was just decimated by the loss of manufacturing jobs. At that time, we had a 59 percent unemployment rate among African-American men. I know it is really no exaggeration. Bureau of Labor statistics.

Also, I think Wisconsin has had one of the groups, the women's business initiative with Wendy Ballman, and they have taken advantage to the extent that they have been available of the SBA products, the micro-lending they have done a fantastic job as a women's organization in promulgating business activity among women. And I became very interested in angel investments, and indeed, I had done another program called the CAPCO program, which was very, very targeted. One of the—so I am really excited about this bill.

I am an author of the ranking member's bill, and one of the reasons why I was interested in that bill was because it recognized the real need for capital, venture capital, but also in terms of when I look at my district, it is important to me to have a diversity in the kinds of businesses that we invest in, and that we really get this additional source of capital down to small businesses that hit the whole socioeconomic strata, and so specifically—like when you gave your example to the Chairman about eMetagen, the research park at Madison.

There's more than one reason to be mad at them, not just because their Madison, it is like they are not Milwaukee and it is not where the unemployment and underemployment exists. So that was one reason why I was sort of interested in a broader initiative that looked at putting the technical assistance, the grant programs together, kind of package that with the venture capital, so you can really capital the network where it would really make the most difference.

It is wonderful to have this extra add capacity for our research park in Madison, but talk to me about how you see venture capital being put together with other initiatives and what is happening in Wisconsin, maybe to direct that to—you know, help low-income areas.

Ms. KEATING HEINEMANN. Well, to address the issue of—I give the one example of eMetagen, Milwaukee, Madison. However, there were 40 companies that were certified, and there were several from Milwaukee. I apologize I do not have that list, but I would be happy to provide that to you. There's some great partnerships that are going on in Milwaukee. And one of them that will reach to all communities is the Governor's Business Plan Contest where any-

one can enter that contest. There's been a tremendous amount—all of the planning is being done in Milwaukee. The governor's business plan conference and entrepreneur's conference will be held in Milwaukee in June, the second week of June, and people are encouraged to apply through that process, and then they get mentored by—most of the VCs, there are two or three VCs that are based out of Milwaukee. So they are really trying to reach down—

Ms. MOORE. There are resources for mentoring and above—in 255, as it passed, there is the venture capital fund, but what other resources are brought to bear, you know, to provide the technical assistance and the other networking opportunities that are not haphazard?

Ms. KEATING HEINEMANN. Well, it is a great question, and I will try to address it. It is the Department of Commerce, Bureau of Entrepreneurship. We have been very active. Pam has been active in going out into the State, certainly in Milwaukee, to try to make people aware of the grant programs that are available so people can write businesses—business plans and then connect them to the Wisconsin Angel Network, which is kind of the center where people can start looking for access to capital. And then we tried to identify the angel networks in all the States, and we put that on the angelnetwork.com Web site, so if someone is seeking capital and a mentor to help them with their business, they should be able to very visibly find out who that name and contact person is and the Milwaukee Angel Networks include the Silicon Pastures and the Golden Angel.

Ms. MOORE. My time is due to expire. Mr. Chairman, am I indulged? Good.

I am very happy, sir, that you have agreed to respond to this question because we are talking about putting a national venture capital program together, so we need to make sure it is part of a package. Go on, sir.

Mr. VILLALOBOS. One thing I would urge you is to consider leveraging the angel groups in the community, we do that locally. So, for example, we sponsor an entrepreneur's conference, which is now in its 22nd year. Through the people from the conference we also—and the angels, we do community college entrepreneurship programs. One of the women that went through that program then we put into the Tech Coast Angels Fast Pitch Competition. She won the competition and got funded. We can show you lots of success stories, but I think you do what I suggest to distinguish between the high-growth companies that are going to become the Microsofts and the other ones that are just myriad, but are the heart of our entrepreneurship. So all I am saying is not to not support them, but you need different programs through the two classes.

Ms. MOORE. That is true. Thank you so much for your indulgence, Mr. Chairman.

Chairman MANZULLO. Thank you. I spend most of my time in this Congress working on manufacturing issues or areas deep in that area, along with Ms. Moore. We make a lot of parts for the Harley-Davidson motorcycle. And whoever wants to tackle this. Perhaps Dr. Sobieski, because of your background in manufacturing and aeronautical engineering. Tell us—I don't want to say

the attitude towards manufacture, but tell us how manufacturers could be helped by this program. Well, what you are doing now or how they could be the beneficiaries of the program?

Mr. SOBIESKI. Well, thank you for that. It depends on what you mean by this program.

Chairman MANZULLO. I am sorry. The angel program. What are you doing for the manufacturers that otherwise would not be available?

Mr. SOBIESKI. I think the answer to that question fits into the context of the several questions we have had here from Representative Moore and Velazquez as well, and that is this distinction that is being made between the so-called high expectation entrepreneurs, which I had to laugh at because every entrepreneur I have ever met is high expectation. And the—I guess what you might call low expectation entrepreneur, the ones who only want to employ—run the restaurant or the corner store or a small manufacturing concern.

You know, my thought, Representative Moore, is that if the next Google started, it is not going to stick around in Milwaukee. No matter what program you have, it is going to migrate somewhere else. And no matter how targeted the—and well intentioned the design of some kind of a structure, if you really want to drive in a job creation and innovation creation, you need to do something that is more environmentally focussed.

It changes sort of the environmental structure that one accesses capital with, rather than pull one's hair out trying to figure out how one can design a targeted program. It is just extremely challenging. We have been, all of us here, in this business for years, and it is still a matter of debate about how it actually really works at the angel level. We all have our anecdotal stories and our gut impressions, but if we were to actually design a program, it would be quite tricky.

And so what is appealing about these tax credit notions is, you know, if you make capital easier to access, it will be just as easy to access in Milwaukee as it is in Madison. And if people run out of high tech entrepreneurs in Madison, they will come over looking in Milwaukee for more of them. And that is the way you would actually create opportunities in every sector, including manufacturing, which is, you know, if you have a choice between investing in \$100,000 to buy a yacht or investing \$100,000 to invest in a sheet of paper that says 10,000 shares of Acme Incorporated, the proposals in the tax credit provisions you are proposing would make that sheet of paper with that stock certificate a little bit more valuable, and you would be a little bit more inclined to maybe forgo the yacht and go for helping out someone.

Chairman MANZULLO. You say that because there are a lot of yacht owners in Milwaukee? Anybody else want—Ms. Preston, do you want to take a whack at that question? Manufacturers.

Ms. PRESTON. A lot of times what we are seeing now with traditional industries and sort of the reawakening of the industry is the application of high technology, of software systems and those type of things to the manufacturing sector, and having dealt with this question in a number of places around the world, particularly such as in Canada, in Alberta, where it is really hard to talk about any-

thing but oil and gas, particularly right now, but telling them that the most important thing for them to do is to diversify their economy is that identifying technologies that have applications in a multiplicity of silos of industries, and one of them is in the manufacturing area.

So I see where the high-tech computer software type of industries can have a multiplicity of applications and actually increases efficiencies in those manufacturing industries, and those type of companies that are adjunct or complementary to the traditional-based industries in those regions do very well because they complement those traditional industries and take them into the 21st century and give them a revitalization.

Chairman MANZULLO. You know, one of the hidden secrets of manufacturing is that people look at Google, for example, as a service. Well, it may be a service, but look at the mass of manufactured items that are used to run that service. You know, from the search engines themselves right down to the individual computers, which obviously are all involved in manufacturing.

Ms. Velazquez, do you have more questions? Oh, I am sorry. Oh, yes, go ahead, please.

Mr. VILLALOBOS. Two quick remarks. We do, as angels, fund manufacturing companies. For example, LandRoller is a roller—it is the next generation of inline skates. Very exotic. It is direct manufacturing. Cargo Tech, they make the shipping packages to be able to ship things that are frozen or very cold. So angels will fund manufacturing companies.

And my second point I wanted to make, the key point I am trying to distinguish is the size of the company. If we provide tax credits, I don't think we should be—I think we should be doing them for two classes, the small start-ups that can grow very fast and the little companies that are the heart of our industry; but if we are not careful with the definition of a small company, we will be funding a Google when it was already \$20 million in revenues or \$5 million in revenues.

I don't suggest that we fund companies that can already get venture capital or other funds easily that we focus our credits and our efforts in truly the little companies, whether they are able to grow large or not because they each have a very strong impact on our economy.

Ms. VELAZQUEZ. Mr. Villalobos, following that, the comments that you were just making, what factors should be included in a new definition of angel investment companies, qualifying companies to ensure that incentives are targeted to the most appropriate companies?

Mr. VILLALOBOS. That they be very early stage; and I don't know if you would want to put implicit criteria, like \$2 million in revenue or less or 20 employees or less, at the time that you are funding them. A company that has got even 25 employees probably is doing 2.5 million or more in revenue, even 100,000 per employee, that is right in the sweet spot of where VCs will come plunging in or a bank will.

So it is that, that they are very small and young, and then distinguish two classes, the ones that are very high risk because that is where you want to put angel money in, and then the ones that

are more what Congresswoman Moore is looking for, to develop the infrastructure in neighborhoods and those you want to find a way to involve again, individual investors that huge pool of 10 million in some way ideally intermediated with an angel group or somebody that can help to make their investment safe but have their own capital at risk.

Ms. VELAZQUEZ. What do you think the Federal Government's highest priorities should be in regard to angel investing? And any of the members of the panel can comment.

Mr. VILLALOBOS. Well, I think the model that has certainly been proven that angel groups, per se, work very well. So that should be one, is help to drive more investors into angel groups, help to elevate the level of professionalism within our angel groups, and then use the angel groups to leverage because again, back to that concept of alignment, if I am in an angel group, and I have got my capital at risk, it is a lot easier for Dan, who may not be an angel, to put in \$5,000 along with me, whereas if he is trying to do it alone, it would be very, very risky.

Ms. PRESTON. Oh, I am sorry.

Mr. LOAGUE. I see innovation is very important because competitiveness is very important. I have been to China, seen some of the things that are going on over there. The angel market, by the way, is developing over there. The technology market. Some of the folks that got their Ph.D. From the University of Maryland are back in China right now, funded by VC companies over there. Innovation is very important, and I think that it cuts through every kind of programmatic thing you are looking at. It goes to more than just low income. It is anything that is innovative, anything that has a high-growth potential, anything that has a global competitive quality is where we want to be at and without participation by angels, we are not going to get there, and that is why this bill is important.

Mr. SOBIESKI. In terms of the Federal priorities, I would differ with Luis that the Federal Government should have any priority in terms of angel groups. I think angel groups are a natural manifestation of the development of the financial food chain. And they are forming on their own, they are figuring out how to operate as businesses, and I would, in fact, be wary of any kind of government incentive or interaction with angel groups because of the danger of perturbing a natural market process that is still good for it.

The tax credit changes sort of the environmental environment in which capital decisions are being made to be deployed. People criticize American society that we are too consumptive, and it is really making someone, to use my yacht example, but that is an extreme. It is making someone make a choice between, should I buy a new car with this \$25,000, or should I invest in that—my neighbor's nephew's company that I heard about that he is looking for \$25,000? Car, piece of paper? Car, piece of paper? Oh, yeah, there is that tax credit. I can get a little bit of a break. Okay. I will give that \$25,000.

So in terms of the prioritization, I would agree with Luis. It should be focussed on that kind of entrepreneur.

Ms. VELAZQUEZ. What about data collection?

Mr. SOBIESKI. I think data collection, no one can complain about data collection. That is an absolute missing piece in the puzzle, and the more data we can get, the better. The danger is, in all data collection is the implied authority by which it is collected. So you have enormously different data between the survey that Luis cited and University of New Hampshire, order of magnitude different data.

And if the Federal Government gets involved in collecting data that has the impromptu of the United States Government, that speaks with great weight. If it is wrong and influences future policy decisions then that is, of course, a danger. The beauty of the venture capital system is it kind of developed in the absence of any of this. It wasn't taken seriously until really Apple Computer started, and then people took it seriously.

Ms. PRESTON. I wanted to add partly to what Dr. Sobieski indicated. I think we need to remember that the vast majority of investments by angels are done by individuals, not members of angel groups, and that process in the economy has been working very well for a number of years, and what we are trying to do is further promote it and enhance it to putting more money into innovative ideas so that angel groups are a relatively new concept here in the United States and elsewhere, and a very interesting and obviously I support them. I have written a book on angel organizations, but I do also recognize that it is, by far, the minority way of investing. And even within angel groups, individual angels make their own decision on investing, and therefore, as Dr. Sobieski was indicating, the process and the economy has its own ways of creating the right system for investing.

When we talk about investing, angels aren't going to be investing in a company that is worth \$30 or \$40 million because they are going to be raising more than \$50,000, \$100,000, \$500,000. That is where angels play. So angels will naturally be investing in companies at an early stage. That is where the market is for them because of the amount of money they have to invest and that the company needs at that time.

And angels, I would like to think, are relatively smart, intelligent individuals that although we do make bad decisions at times, but we play the odds. We are right some of the times, and we make money doing this. And that process is part, again, of that process, just like venture capitalists develop, angels are developing in a much more sophisticated way and do a very good job on their own of investing.

These are highly independent autonomous anonymous individuals that don't want their name in databases and aren't interested, for the most part, in joining groups. However, that is not to say angel groups are bad. I think they are a fabulous idea. I just don't think it is something that we necessarily need the government to interject themselves into.

Mr. VILLALOBOS. Well, two comments. One, I would question, one, we know in any level that the investment by these, quote, large group of angels of some 220,000 angels that we know the results of. I would challenge anybody to produce anything that remotely claims some kind of results from that investment. I don't think we know who they are. I don't think we can—I would like to see anything that supports that statistic. I don't think it exists.

And the second point is, I think the ranking member's approach to the angel groups to provide a co-investment fund that recycles and puts the profits from that back into that fund, I don't think it would perturb the ecocycle of the angel groups any differently than providing them credits.

You are essentially giving a credit to an individual. You can give them to the angel group; and the thing I like even better about that is it recycles the money back into that pool. So it keeps on fueling. Either of the two I can support, but I think—I don't see any problem with disturbing that ecosystem.

Ms. PRESTON. One of the things we need to remember regarding the ACE Act is the one piece at the end for a taxpayer to have the ability to use a tax credit is the separate document that they file with their IRS return that indicates the name and the Tax Code number of the company to which they are requesting a credit.

Therefore, we probably have the ability to gain more information about angel investors than we ever had before, including the 225,000 from that simple reporting requirement. It has the opportunity of being one of the most invaluable pieces of information we could get in a passive manner for the Federal Government.

Chairman MANZULLO. Mrs. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman. You may have covered this. I am sorry I got here late. Very busy day for a lot of us. I represent the 19th district in New York and in New York State. I understand that angel investors in New York State actually are—we have a tax incentive that is available to angel investors. What I am concerned about is that New York's tax incentive that is available to our investors could be destroyed by the AMT. I want to know if it is correct that tax exempt funds that would be created by this bill would still be subject to the AMT, unless we reform the AMT so that these things don't get wiped out. Anybody want to talk to me about that?

Mr. VILLALOBOS. Well, the assertion was made at the angel capital, at the annual meeting that that was the case, but there was no basis given for it, but somebody said that they had looked at it, and that the tax credit would be illusory because for most angel investors, the AMT would kill it. Now, that was just made as a bald assertion with no backing for it. So, and people were concerned, but I couldn't tell you.

Mr. SOBIESKI. I think that comment also highlights the distinction amongst angels. That was indeed a comment. We were both at this angel capital association conference, and the feed back was, oh, the tax credit is great, but if you really want to spur investment, get rid of that AMT thing but again, these are extremely active angel investors who tend who invest in companies like Luis was describing that have the potential to become the next Google. It is not the small nephew's company employing six people making widgets and that would be sold locally. The tax credit, in its pure form, might very well be that beneficial to the vast majority of angels who only make one or two investments a year of the 25,000 to 50,000 size piece. It may arguably be less helpful to say members of my organization, who may be extremely helpful in investing hundreds of thousands of dollars in high-growth companies and they tend to have lots of other income that may very well be inter-

fered with the AMT but in terms of the overarching goal unleashing innovation across the board in every community from Madison to Milwaukee and in every different kind of little company as well as potential companies that might become Google, I don't know if AMT would be as much a disincentive.

Mrs. KELLY. I take it from your comments, none of you on this board would know whether or not the current AMT we have going forward would wipe out that New York State tax incentive? You do not know for sure?

I wanted to ask you, Ms. Preston. You were talking about the ratio of the potential angel investors to active angel investors. It is pretty big.

Ms. PRESTON. Yes, it is.

Mrs. KELLY. I would like to know what kind of an improvement to that ratio you would expect if we had a Federal tax incentive. You think that would be a better—that ratio would change? And how?

Ms. PRESTON. I think it would take the ratio to having individuals that are, right now, either sitting on the fence or have not done angel investing. It would give them that final incentive to look more seriously at the opportunity because in some respects, up-front investment tax credit, as we are proposing, reduces the risk, and so it gives them an inducement to make that investment that they might not otherwise make.

And as Dr. Sobieski was saying, between buying the yacht or putting the \$100,000 into the company of interest, that provides a greater benefit to do that. So yes, and we have had anecdotal responses from a number of angels out there that have said, this is fabulous. I can get more individuals involved directly in angel investing, and I think Secretary Heinemann, her experience in Wisconsin bears that out.

Mrs. KELLY. So what you are saying you think instead of seven to one or ten to one, we would get a far better ratio with a split like five to four or something, people digging in, doing something like—actually getting involved as angel investors.

Ms. PRESTON. Even if we get a 10, 20 percent, 20 percent increase, when you look at \$23 billion right now estimated being invested or other numbers you look at, that is a significant additional money into our economy to create jobs, and to advance innovation.

Mrs. KELLY. Okay. Thank you. I am out of time.

Chairman MANZULLO. Let me ask this question: How far should government get involved in what you are doing? Secretary Keating, you seem to draw a very clear line between a government function; and private functions. I appreciated your answer.

Ms. KEATING HEINEMANN. Well, I think the government can drive investments from the standpoint of providing incentives. And I would like to just kind of address, and I guess Ms. Velazquez mentioned, and also Congresswoman Moore talking about urban communities and also businesses that need to be funded in areas that might be low-to-moderate income.

And I think if you, you know, tossed around the idea of putting a Federal tax package together, that had some type of incentives maybe to focus on those particular areas, and the most need for those types of businesses, certainly if, you know, the government

were to put those incentives in place, usually the investors follow that particular incentive if the business is a good business opportunity for them.

And, you know, I will just give you an example. I regulate banks, and I have done, you know, I have seen a lot of data on angel investing and the majority of bank decision makers who is deciding who is getting those loans are not women or minorities. I mean, they make up less than 12 percent. And if you look at the angel investing, less than 8 percent of the angel investors out there are women. So when you are a person going to look for access to capital, if there is something that drives them there, some type of tax credit, that they are actually seeking to invest in your type of business, I think that is a good incentive.

And when we were talking to the phenomenal angel fund yesterday and their focus is women and minorities, they are very interested in actively pursuing these businesses, and one of them is in Resina. That is a manufacturing company, and the woman is the CEO, and she has had an extremely difficult time finding capital for a very high-tech, high-growth-type business. And phenomenal funds is now looking at them because now they know that, you know, there's this tax package out there, 25 percent credit for seed funds, and their seed fund is focussed on this particular area. So I would just target your policy around where you want the results.

Chairman MANZULLO. Ms. Moore—I jumped ahead of you. I am sorry.

Ms. MOORE. Mr. Chairman, you can always jump ahead of me, but you know what, thanks for yielding because I have got a group of constituents outside waiting on me. And I will be brief, Mr. Chairman.

Thank you so much, Madam Secretary, for revisiting that question, because I was feeling a little bit perplexed by some of the comments that Dr. Sobieski made, and perhaps you have answered that. He said that he would be, you know, and if I am characterizing them incorrectly, please let me know.

You said that you would be concerned about the government directing some of the creating incentives, perhaps, for tax credits to go in a certain place. And that you would rather see sort of the market forces drive that decision.

And I think the Secretary just said, you know, we can create a market by having certain priorities because, for example, there are people who want to do socially responsible investing. You know, they might say I want to invest my money in only environmentally pure activities. And they can actually create an opportunity for somebody who wants to do that, who wouldn't otherwise have an investor. They may say, we want it targeted. I want to help women get themselves together. I want to help minorities. I want to help new immigrants. I want to help this region. You know, I am Magic Johnson from this particular inner city community, and I want to give back to that particular community.

And only God knows why certain things like the Cabbage Patch Doll or Pet Rocks or Elmo made it, but for the fact that they had enough money to do it. So it seems to me that, you know, that I think the government can do a great deal toward providing grants and incentives and so forth. And, you know, as the Secretary sug-

gested, not invest in projects that don't have any prospects, and I think many of you have said it already here today. That I think, it was Mr. Loague. How do you say your name?

Mr. LOAGUE. Loague.

Ms. MOORE. Loague. Some are going to make it; some are not going to make it. I think if we give tax credits, that we do, as a government, have the right to create some expectations. I mean, we don't have any doctors in a certain rural area. We want to create incentives for medical facilities there. That we can sort of direct this. And I just want to sort of—I wanted you to clarify what you meant by we should just let the market do it. I mean, I am a capitalist, but free fall and capitalism are kind of different things.

Mr. SOBIESKI. Sure. Thank you. I think we are actually in agreement. I was tailoring my comments to the provisions in one of the bills that would have the SBA provide grants to angel groups with a targeted focus on certain areas of investing, which I felt was just given the scope of the problem that you outlined, which is copied across the country, is not going to be nearly as effectual as tax credits could be. And they could be targeted tax credits.

I think, though, that that would be orders of magnitude more effective than attempts to design a program that would give grants to an angel group to invest in certain kinds of deals in certain areas.

Ms. MOORE. Okay.

Mr. SOBIESKI. If you just created, say, tax credits for women and minorities, that would be hugely more effective than having an effort inside the SBA to give money to angel groups to invest in women and minority groups. So I am a big believer in the ability of the government to create incentives. I am just arguing that it should be done with tax credits, not with additional bureaucracy or design programs.

Ms. MOORE. Thanks for that clarification.

Mr. VILLALOBOS. Yes, Congresswoman. I think I agree—I know I agree with Ian, but I think the area that we are talking differently is, which companies are we talking about?

If you are talking about the ones you are interested in, creating that broad level of economic activity, then I think a tax credit, a broad tax credit is great, provided you don't allow that tax credit to be used to be investing in companies that are far along, you know, much more developed.

If you are looking to create jobs and growth overall, then the focus is on the ones that can grow very fast, and I am not saying we shouldn't do both. I am just saying, separate those two programs and don't try to use the incentives from one to the other.

The other point is, if I am understanding this right, if you give me a tax credit, you are not reducing my risk. Or if you do, the program doesn't work.

Let us say I am going to invest \$100,000 in a venture. Well, if you give me a tax credit and I only effectively invest 75, we haven't won at all. We haven't expanded the investment base. So for this to work, if I am going to invest 100,000, you give me the tax credit for 25, and I am going to reinvest that 25 you gave me, now we have grown the capital pool. And again, if I am looking at that venture, if I am investing 100,000 versus 75, my risk is that it goes

all down the tube. The only thing you do is cut down the amount I have at risk. Not the risk. The risk of that company going broke is the same if I put 75 or a hundred in it.

So we have to be careful, and we need to make sure that the program, and I think the program, a tax credit would stimulate me if I will invest 100,000, I will invest 100,000. If I get 25 credit, I will invest that too.

Ms. MOORE. Thank you so much. And thank you, Mr. Chairman.

Chairman MANZULLO. Thank you. This has been very interesting. I ran into a gentleman last night, Adam Heller. He is a floor trader, is that it, at the MERC and wanted to do something different in his life, and he bought a sheet metal fabrication company in Galva, Illinois. It has 35 employees. And he had a very difficult time convincing anybody that somebody who was a floor trader could run a factory. And I said, well, I could understand the concern with that question. But he has done the most amazing thing. He has taken all the market principles he learned on the floor, including his wealth of knowledge in international relations to successfully own and run a company that does classical sheet metal fabrication. They also make point of display fixtures, such as the rug samples that are held on display at Home Depot. They manufacture those. He has been able to begin exporting those to Europe?

So I had never met anybody who came from the financial world who just wanted a change in his life and went into manufacturing. I was very impressed because I think this shows the power of the angel investors, and the wealth of knowledge that they can give to somebody who is involved in manufacturing, because it is not just the money, but it is the know-how and advice that can take the investors' capital along, obviously with that of the entrepreneur's capital, and make that work in seemingly impossible situations.

Well, I want to thank you all for coming. You came from Washington and Wisconsin and California. Dan, you came last, but that is because you are the closest.

Mr. LOAGUE. That is right. I got caught up on the Metro. I used to live next to Lorrie, though.

Chairman MANZULLO. You did? Where?

Ms. KEATING HEINEMANN. Well, in Madison. He was in Madison.

Mr. LOAGUE. We were in Madison together.

Chairman MANZULLO. Ms. Moore isn't here. You are ganging up on us now. I appreciate it. You have really shed a lot of light on this subject. I can't tell you the tremendous amount of interest that there is in this. And a lot of it has to do with the fact that the participating securities program was eliminated. But if something can be picked up in the private sector, so be it, and more power to you.

And thank you for coming. This hearing is adjourned.

[Whereupon, at 3:45 p.m., the committee was adjourned.]

Committee on Small Business
Hearing - *Bridging the Equity Gap: Examining the Access to Capital for Entrepreneurs Act of 2006*
Room 2360, Rayburn House Office Building
May 10, 2006, 2:00 PM

Opening Statement of Chairman Manzullo

Good afternoon and welcome to this important hearing. On April 26, 2006, I introduced H.R. 5198, the *Access to Capital for Entrepreneurs Act of 2006* or ACE Act, with Representative Earl Pomeroy, our minority colleague from North Dakota. This bipartisan measure provides a mechanism for our nation's small businesses to obtain critical equity funding. It does so by establishing a tax credit for the individuals and partnerships most likely to provide equity funding to small early stage companies. The purpose of this hearing is to examine and discuss the angel investor market and its potential effects on small business through the implementation of the ACE Act.

The ACE Act was patterned after successful programs in 21 states, eleven of which have representation on this committee. These states include: Arizona, Colorado, Hawaii, Indiana, Iowa, Maine, Michigan, Missouri, New York, Ohio, and Wisconsin. These state tax credits have materially helped increase the amount of early and emerging company financing being provided to our nation's small businesses. Today, a government official from Wisconsin is going to provide information on how the Wisconsin state tax incentive is working.

The ACE Act provides a needed boost to our nation's qualified small businesses by helping angel investors increase equity stakes in these companies. If the provisions of the ACE Act were signed into law, many small businesses which would otherwise fail for lack of adequate resources could grow and expand, creating more jobs for Americans. The United Kingdom already has a similar tax program in place that encourages new investments in emerging and early stage companies. UK's incentive has proved extremely popular and resulted in the influx of tremendous amounts of capital. We want to provide the same type of incentive to the growing and emerging small businesses in our own nation.

I now yield to the ranking minority Member, Rep. Velázquez of New York, for her opening comments.

STATEMENT
of the
Honorable Nydia M. Velázquez
House Committee on Small Business
Hearing on “Bridging the Equity Gap – Examining the
Access to Capital for Entrepreneurs Act of 2006 (ACE Act)”
May 10, 2006

Thank you, Mr. Chairman.

Access to capital is the key to success for any small business. But in today’s economy, this is easier said than done – and many entrepreneurs need all the help they can get in securing the capital needed to start and run their businesses.

Venture capital has long filled this role by putting seed capital directly into the hands of small business start-ups. Unfortunately, this source of financing is simply not accessible to many entrepreneurs starting out today – particularly women and minorities.

That is why initiatives such as the Small Business Investment Company (SBIC) are so important in filling this gap. This program had a proven track record, making an average investment per business of around \$1.1 million – serving as a critical source of capital for early stage businesses. Now that the SBIC Participating Securities program has been shut down for over a year, with no plans for reopening, the need for such a government initiative has become more important than ever.

As we will hear today, angel investors are working to fill this role. A lesser known and less formal alternative to traditional venture capital, angel investing is truly the wave of the future for thousands of small business start-ups across the country. Last year alone, there were 225,000 active angel investors in the U.S. who invested \$23 billion in small businesses.

By focusing directly on early stage and growing entrepreneurial ventures that have faced difficulty in securing equity financing – this is the avenue for getting much-needed capital into the hands of our nation’s small businesses. These entrepreneurs are some of the most innovative out there – and these are the types of high risk, high reward investments that will pay off in the long run.

The question is – how do we make angel investing a viable source of financing for this nation’s entrepreneurs? Clearly, the obvious first step is providing tax credit incentives for angel investments in qualified small businesses. Investment Tax Credits (ITCs) for equity funding provide a good incentive to spur these investments in small firms. This is an important step in nurturing local companies with increased early stage financing – but on its own, tax credits are simply not enough.

We need to make sure that the SBA is involved in this process. As the only agency tasked with assisting this nation's entrepreneurs – it is the SBA that truly understands the challenges small businesses face, has experience in helping business owners, and knows the importance of involvement at the local level. This built-in support system would provide both small businesses and investors alike with good, reliable advice – assistance that would go a long way in spreading angel investment to companies across the country.

We also need to commit more to assist women and minority-owned businesses – sectors that have traditionally faced difficulty in accessing equity financing. These companies have the potential to infuse innovative, new ideas into the economy – which makes angel financing a good investment. It is clear that they need these investments as well – and angel funding must be a viable source of financing for the next generation of women and minority entrepreneurs.

Clearly, angel financing is of vital importance to small businesses. As the economy continues to rely on entrepreneurs to spur job growth and stimulate economic development, the need for such an initiative only grows. In that respect, we need to consider a variety of proposals in an effort to provide the best investment for our nation's businesses and the future of the U.S. economy. Thank you.

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Earl Pomeroy
Congress of the United States
North Dakota

Statement of Representative Earl Pomeroy
Small Business Committee Hearing:
Access to Capital for Entrepreneurs Act
May 10, 2006

WASHINGTON OFFICE:
 1501 LONGWORTH HOUSE OFFICE BUILDING
 WASHINGTON, DC 20515
 (202) 225-2611
 REP.EARL.POMEROY@MAIL.HOUSE.GOV
 DISTRICT OFFICES:
 ROOM 328, FEDERAL BUILDING
 220 EAST ROSSER AVENUE
 BISMARCK, ND 58501
 (701) 224-0255
 3003 32ND AVENUE S
 SUITE 6
 FARGO, ND 58103
 (701) 235-8760

Mr. Chairman and Ranking Member Velázquez, I would like to thank you for the opportunity to testify before the committee today. The Access to Capital for Entrepreneurs (ACE) Act is the result of a great deal of hard work on the part of a group of experts, Congressional and Committee staff. I have appreciated the opportunity to work with Chairman Manzullo on this legislation. It represents an opportunity for our nation's small businesses to obtain critical equity funding by establishing a tax credit for the individuals and partnerships most likely to provide equity funding to our nation's early stage companies.

The Access to Capital for Entrepreneurs Act, H.R. 5198, will provide a 25% tax credit for investment in qualified small businesses. This investment is capped at \$250,000 per investment and \$500,000 per individual investor. Such a tax credit for investments at those levels will incentivize the type of funding infusion small businesses need.

We have seen that this type of program works. More than 20 states, including my state of North Dakota, have instituted similar programs with tremendous success. North Dakota was one of the first states to offer such a tax credit for investments in entrepreneurial ventures. Initially instituted in 1989, it has been updated several times over the past 17 years. In its current form the North Dakota Seed Capital Tax Credit offers a 45% tax credit for qualified investments. The North Dakota tax credit has many of the same eligibility requirements as the Access to Capital for Entrepreneurs (ACE) Act.

One example of the effect that this type of tax credit can have from North Dakota is LAS International. LAS is a manufacturer of innovative water and wastewater treatment systems and equipment, located in Bismarck, North Dakota. With the help of the North Dakota credit, LAS was able to raise \$2 million dollars, between 2003 and 2005, to increase manufacturing and export capabilities and increase its engineering support capabilities. This increase in available funds leads directly to an increase in opportunity in the local labor market.

During the development of H.R. 5198 many experts in the field of small business development were consulted. One such individual, Bruce Gjovig with the Center for Innovation at the University of North Dakota, was also instrumental in the development of the North Dakota Seed Capital Tax Credit. The Center for Innovation has won several awards of excellence in innovation and entrepreneurship over the years while fostering over 400 startups that have

attracted over \$110 million in investments. By applying the experience and knowledge gained over the years at the Center for Innovation, H.R. 5198 makes happen on the federal level what we have seen work so well in North Dakota.

In addition to the input of individuals such as Bruce Gjovig we have received input from experienced Angel investors. Angel investors are critical to the development of many early stage companies due to their willingness to invest in developing businesses. H.R. 5198 will provide a valuable incentive for these individuals to invest in small businesses that are early in development or are in need of fresh capital to expand and add workforce. Without such an incentive many Angel investors may be hesitant to invest in some early stage small businesses thus stunting the growth potential for businesses all over the country.

Again, thank you for holding this hearing today. I look forward to working with you to advance this legislation.

**Statement
of
Susan L. Preston**

**Before The
United States House of Representatives
Committee on Small Business**

May 10, 2006

Chairman Manzullo, Ranking Member Velázquez and Members of the Committee:

A. Introduction

Thank you for inviting me to testify regarding the Access to Capital for Entrepreneurs Act of 2006 ("ACE Act"). To provide context for my testimony, I offer a brief summary of my background and expertise. (Attached is a more complete resume). My testimony reflects my expertise and knowledge of the private equity market, in particular angel investing.

For the past six years, I have been an Entrepreneur-in-Residence (E-in-R) with the Ewing Marion Kauffman Foundation, an internationally recognized foundation dedicated to the advancement of entrepreneurship in the United States. One of the most critical issues for entrepreneurs is the availability of financing for creation, development and growth of a business venture. As an E-in-R for Kauffman Foundation and an experienced angel investor, I focus much of my professional efforts on the subject of angel financing of entrepreneurial ventures: understanding that economically vibrant communities are created through the support of entrepreneurial endeavors. In addition to my angel financing activities, my first three years with Kauffman Foundation included developing strategies, conducting programs and generally advancing the cause of women entrepreneurs.

My experience related to angel investing includes:

1. Author of *"Angel Investment Groups, Networks and Funds: A Guidebook to Developing the Right Angel Organization for Your Community"*, a comprehensive guidebook on the establishment and operation of angel investment groups.
2. Contributing author to *"State of the Art: An Executive Briefing on the Cutting-Edge Practices in American Angel Investing"*.
3. Founder of Seraph Capital Forum, an all-women's angel investment group in the Seattle, Washington area.
4. Currently working on next book on entrepreneurs guide to angel financing scheduled for printing by Wiley Publishing in Q1 2007.
5. Author of numerous articles on private equity financing, particularly angel investing and angel organizations.
6. Member of the Advisory Board for the Angel Capital Education Foundation, and founding member and Treasurer of Angel Capital Association (ACA), a professional alliance of angel organizations.
7. Frequent international speaker and instructor on private equity financing and economic development for groups such as, Goldman Sachs, Northern Trust, NYU Business School, OECD double ministerial conferences, Industry Canada, Alberta California Venture Channel, Angel Capital Association, Angel Capital Education Foundation, National Angel Organization, National Association of Seed and Venture Funds, State Science and Technology Institute, National Business Incubation Association, Midwest Association of Seed and Venture Funds, the Jamaican Government, Governor's Conference on Economic Development, Washington state legislation, State of Wisconsin, Pittsburgh Venture Capital Association, and many others.
8. Invited to speak at the upcoming World Conference on Women Entrepreneurship and Access to Capital in Stockholm, Sweden.
9. Cover story in Red Herring (December 2005) on women angel investors, profiled in INC Magazine, USA Today, Business Week and numerous other local and national

- publications on angel investing, private equity financing and women's entrepreneurship.
10. Chair of the Entrepreneurship Center at Seattle University, advancing the Center through cross campus entrepreneurial programs and community out-reach engagement of students, faculty and business leaders in micro-enterprise programs.

B. Background on ACE Act

On April 13, 2005, I testified as an expert on angel financing and the funding gap during the hearing on the Administration's FY 2006 budget proposal for the Small Business Investment Company (SBIC) program. The White House ultimately de-funded the SBIC Participating Securities program. As a result of this de-funding and the loss of critical early-stage funding for young companies, Chairman Manzullo called for solutions to this funding loss. Shortly thereafter, I contacted the Committee with an outline for a federal income tax credit, which has become ACE Act.

The ACE Act is modeled after similar legislation in 21 states for the promotion and advancement of small businesses, which are the growth engine for local and national economies. These 21 states are: Arkansas, Arizona, Colorado, Hawaii, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Missouri, New York, North Dakota, Ohio, Oklahoma, South Carolina, Utah, West Virginia and Wisconsin.

Considerable work and consideration went into the development of HR 5198, including the establishment of a working group of experts in private equity financing, to include representatives from national organizations for private equity financing and representatives from states with incomes tax credits similar to ACE. This working group represents qualified, knowledgeable individuals with regard to the success of, and issues associated with, tax credits for private equity investing. Roundtable discussions with the working group were highly informative and valuable in defining many critical structural aspects for ACE. Therefore, ACE represents the best of state programs and benefits from the lessons learned by these states in the development and implementation of their programs.

HR 5198 is a simplistic, self-executing federal income tax credit for early-stage investors, (i.e., angel investors, as individuals or in partnerships), which will promote investing to help grow young companies. This funding inducement through risk reduction (i.e., tax credit) provides critically needed growth funds, particularly in the funding gap before venture capital financing is available to young companies.

C. Discussion

Funding Gap: The development of any entrepreneurial venture requires funding at various stages of development. As discussed in this testimony and supported by facts from MoneyTree™ Survey, National Venture Capital Association, Center for Venture Research, Dow Jones Venture One and other sources, venture capital is no longer a realistic source of financing for the critical seed and start-up phases of a company's development – creating a funding gap for which entrepreneurs must seek other sources of funding.¹ This

¹ MoneyTree™ Survey defines the various stages of investment as:

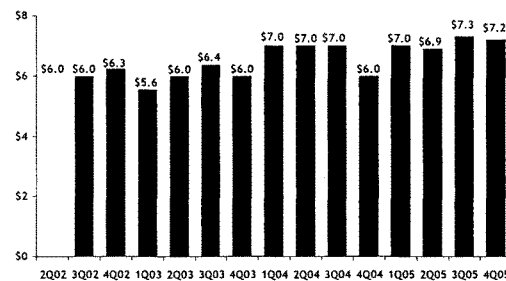
1. Seed/Start-Up Stage: The initial stage. The company has a concept or product under development, but is probably not fully operational. Usually in existence less than 18 months.

“other source” or the principle source of early stage financing comes from angel investors. Policies and legislation which encourage angel investing, lower the barriers to investing, and do so in an environment of minimal governmental involvement will increase total dollars invested in early stage companies – the very aspects of this legislation.

Historically, the funding gap between investments made by friends and family and the point at which companies could obtain venture capital financing was between \$500,000 and \$2 million in invested capital. However, with venture capitalists moving further up the funding chain with fewer and fewer investments early in a company's development, this funding gap has expanded significantly. Now, as shown in Graph 1, venture capitalists invest an average of \$7 million per deal, an amount far above the needs of companies in the early stage of development.

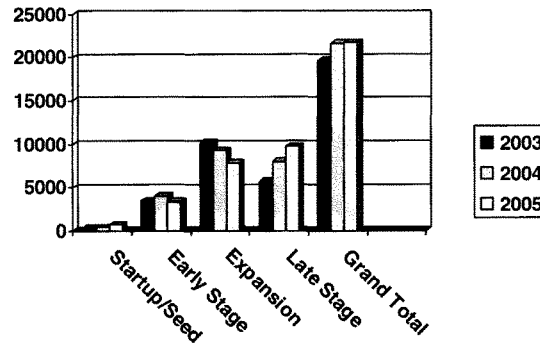
Graph 1

Median VC Deal Size Consistent Median Amount Invested Per Financing Round



In fact, in 2005, of the \$21.7 billion invested by venture capitalists, only 3.3% was invested in seed/start-up companies. Graph 2 illustrates this point:

2. Early Stage: The company has a product or service in testing or pilot production. In some cases, the product may be commercially available. May or may not be generating revenues. Usually in business less than three years.
3. Expansion Stage: Product or service is in production and commercially available. The company demonstrates significant revenue growth, but may or may not be showing a profit. Usually in business more than three years.
4. Later Stage: Product or service is widely available. Company is generating on-going revenue; probably positive cash flow. More likely to be, but not necessarily profitable. May include spin-outs of operating divisions of existing private companies and established private companies.

Graph 2: Venture Capital Investments By Stage of Development

The reasons for this alarming and precipitous drop in funding are multi-faceted. First, since the bust, venture capitalists have been re-investing in their portfolio companies, rather than new investments. Second, because of the size of venture capital funds, often several hundred million dollars, it is not cost-effective for venture capitalists to go through the often arduous task of due diligence and then ongoing investment stewardship for an investment less than \$5 to \$7million, and later stage investments represent less risk, in theory, and are consistent with standard venture capital fund 10 year closure and liquidation language.

Angel Investments:

Term: Angel investors have proven themselves to be an integral part of the capital market, particularly for funding seed/start-up companies. The term "angel" originated in the early 1900s and referred to investors who made risky investments to support Broadway theatrical productions. Today, the term "angel" refers to high net worth individuals, or "accredited investors," who typically invest in and support start-up companies in their early stages of growth. In addition to the value provided by early funding, angel investors are typically experienced professionals who can offer wisdom and guidance to the entrepreneur and who have the patience to allow time for normal company maturation.

Investment Activity At Critical Stage: In the financial world today, angel investors are a critical and essential part of a healthy economy. Experts estimate that, on a cumulative basis, the level of investments made by angels over the last 30 years has been double that of investments made by venture capitalists.² The Center for Venture Research at the Whittemore School of Business and Economics at the University of New Hampshire estimates that angel investments for 2005 were approximately \$23.1 billion in 49,500 deals (compared to \$21.7 billion in 3,939 deals by venture capitalists). These investments were

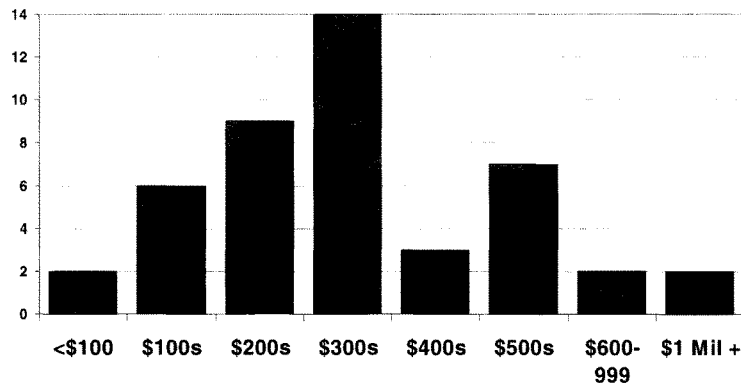
² According to statistics published by the National Venture Capital Association and the Center for Venture Research, University of New Hampshire

made by an estimated 227,000 active angel investors. The majority of the 49,500 deals in 2005 were in the seed/start-up phase of entrepreneurial company development.

Inducing Nascent Angels: Along with angel investment focus on early stage investing, IRS statistics on individual wealth/income suggest that the number of potential angel investors to active angel investors is between 7 to 1 and 10 to 1. Therefore, legislative initiatives which encourage current and nascent angel investors, whether individually or through groups, will infuse capital in the economy. This legislation provides such incentive through reducing the investment risk and hurdle to investment decision by the federal income tax credit for accredited investors.

Simplicity and Compatibility With Angel Investment Process: ACE has a number of other valuable attributes, including simplicity in utilization as a self-executing tax credit, like many existing tax credits. This self-determination minimizes bureaucracy, which is consistent with angel investors' independent nature. Most angel investors are still "lone rangers", or not involved in angel organizations. Angel organizations are growing rapidly in the United States and elsewhere as an intelligent and logical manner for angels to share investment due diligence and see quality deal flow. But even with this increase of angel organizations, the majority of these organizations are still structured such that individual angel members make their own investment decisions.

Proper Tax Credit Amount: The size of the tax credit is also well aligned with the typical angel investment amount. The results of a recent ACEF survey (see Graph 3 below) show that most angel groups have an average investment per deal of \$100,000 to \$500,000 (median= \$300,000). No viable research data exists on individual, independent angel investors, which make up the bulk of angel investors. However, the ACEF data does give us an idea of the investment range. Similarly, the ACE Act proposes a single investment limit of \$250,000 per investor and an annual per investor investment limit of \$500,000. Additionally, because ACE Act's tax credit is structured on an individual investment basis, angel investors, whether lone rangers or as part of a group (investing independently or collectively) may take advantage of the tax credit. This range is supported by doing simple math on the total estimated investment amount and the number of deals from the Center for Venture Research. According to the Center, angels invested \$23.1 billion in 49,500 deals; this works out to approximately \$468,000 per deal.

Graph 3: Average Investment Per Deal By Angel Groups

Source: Angel Capital Education Foundation

Cost Understood: The cost of ACE Act is quite straight-forward. With essentially no bureaucracy, ACE Act does not ask the government to spend money on developing and administering programs to give money to the rich, but rather offers a self-executing tax credit, which can be simply calculated. As indicated previously, we estimate that angels invested \$23.1 billion in 2005. With a 25% tax credit, the direct costs would be \$5.775 billion per year.

Angel investments helped create 198,000 new jobs in the United States in 2005, or four jobs per angel investment. However, this tracks jobs created at the time of the angel investment and thus it is likely that this job creation of 198,000 is the minimum number of jobs created by angels in 2005³. "Since the angel investment is used by the venture to fuel growth, launch new products and explore new markets, it is highly likely that the number of jobs created by the angel investment will increase as the firm grows," according to Dr. Jeffrey Sohl of the Center for Venture Research.

D. Summary

Of course the dynamic value of the tax credits in growing emerging small businesses in our own nation, and the positive contributions to our nation's economy are not included in this calculation, but are obvious. Ultimately, the ACE Act will allow our smaller firms to grow and expand, creating new jobs and increasing our global competitiveness. Every Fortune 100 company started as a small business, which grew and prospered as a result of capital investments, particularly at the early stages of development. ACE Act specifically targets and facilitates investments by individual and group angel investors at

³ March 27, 2006 Press releases "CENTER FOR VENTURE RESEARCH: 2005 ANGEL MARKET EXHIBITS MODEST GROWTH"

this early stage through partial mitigation of the high risk associated with early stage investing through a federal income tax credit. The bill makes good sense from all aspects – good businesses, sound legislation and proper investment encouragement in our economy.

**Statement
of
Dr. Ian Patrick Sobieski, Ph.D.**

**Before The
United States House of Representatives
Committee on Small Business**

May 10, 2006

Chairman Manzullo, Ranking Member Velázquez and Members of the Committee:

A. Introduction

Thank you for inviting me to testify regarding the Access to Capital for Entrepreneurs Act of 2006 ("ACE Act"). To provide context for my testimony, I will provide here a brief summary of my background and am attaching a more complete resume for the Committee's information. My testimony reflects my expertise and knowledge of the private equity market, in particular, the important segment known as angel investing.

B. Personal Background (gives context to your testimony)

I am currently the managing director of the Band of Angels. This organization is based in Silicon Valley and is made up of approximately 100 individual members. To become a member one has to be an SEC accredited investor, be an active angel investor, and have been the founder or senior officer of a high tech company earlier in one's career. Among our membership we have the founders of: Symantec, Logitech, and National Semiconductor and senior executives from: Apple, HP, and Intel. The average Band member is 56 years old and interested in staying involved in high technology enterprises without the need to do so full time. I manage a process at the Band of Angels where we examine 50+ startup companies each month and evaluate them as potential investments. Of these 50, the Band of Angels typically invests in one per month. Last year, the Band invested in 12 startups companies. Entrepreneur Magazine ranks the top 100 sources of capital for startups each year, and each year the Band has been ranked among the top 15.

The Band is usually the first source of capital for the companies we invest in. It is fair to say that, without us, some of the companies we funded would never have otherwise gotten started. Consider then, that in our 11 years of operation, the Band has invested in more that 180 companies which went on to employ more than 3,500 people. Nine of these companies eventually went public; 33 were acquired for a profit to the investors, and more than 60 have gone out of business and were a complete loss. But as a winner or loser, every company that was funded employed people, gave innovation a chance, and let someone try to actualize their dream.

Prior to 1997, when I joined the Band of Angels, I worked at a variety of small startups, the most famous of which was an internet company named Evite.com; later sold to TicketMaster/CitySearch. Earlier, I had a separate career as a scientist. I have a Ph.D. in Aeronautics and Astronautics from Stanford University where my thesis was on the decomposition and optimization of massive design problems into parallel processes. I worked as a research scientist for Kaman Aerospace on a subcontract to the US Army for development of anti-missile systems and held a Secret clearance. My undergraduate alma matter is Virginia Tech where I received a B.S. in Aerospace Engineering and a B.A. in Philosophy. I grew up in Hampton, Virginia and am delighted to be back in my neighborhood to speak with you today.

C. Statement on Access to Capital for Entrepreneurs Act of 2006 (ACE Act)

HR 5198, the ACE Act is a simple bill which will create high technology jobs, accelerate innovation, and enhance American competitiveness in the world. The bill is complementary to the government's established support of innovation through SBIR and NIH grants, the SBA, and long-standing efforts to aid in the commercialization of technology from universities. HR 5198's simplicity provides a minimum risk of unintended consequences.

We take for granted now the existence of the venture capital industry as an established source of capital for entrepreneurs wishing to start a venture. But two things may surprise the committee; one is that venture capital, as an industry, is younger than your youngest member. The second is that it is not the primary source of capital for young start ups.

The financial food chain in the United States is ever evolving. In 1860, when Cyrus Field had the dream of laying a telegraph cable across the Atlantic Ocean there was no place else to turn except wealthy individuals. Banks did not make loans of this type, and there was no venture capital industry to support his vision. A hundred years later, when Robert Noyce contemplated leaving Fairchild semiconductor to start Intel, there were still no professional VCs, but the investment banks had developed enough to fund a high risk, technology driven, asset-less, business plan. This success in part catalyzed the formation of the first pure Venture Capital funds in the late 1960s; yet it still took twenty years for this industry to be recognized as a new piece of the financial food chain. Back then, there were a variety of business models for structuring a VC. But by the 1980s, the model had matured and is now standard: a pool of money is committed by investors, professional managers get a fee on this money and deploy it into very high risk ventures. The managers get 20% of the profits and the fund must be wound up in 10 years. The story of venture capital is the story of legal and financial innovation that created a conduit for capital to flow to a riskier class of investments than was previously possible. By 1980, VC was ready to bet on two shaggy haired nerds in their garage: Steve Jobs and Steve Wozniak.

But Venture Capital is not the final solution, or even the first rung, of the financial food chain. I personally know an investor who turned Jobs and Wozniak down for seed funding because he couldn't abide the fact they were not wearing shoes when they pitched him for an investment. Aside from personal proclivities, Venture Capital does not, and structurally can not, provide the capital needs of all the entrepreneurs starting companies. Venture funds are managed for 10 years and thus shy away from investments that may take longer than that to achieve liquidity. The size of the venture funds demand that the average investment size be on the order of a few million dollars. But many companies need a few hundred thousand dollars first, to prove they are worthy for the multi-million dollar investment. Where do these entrepreneurs turn?

Angels are the answer. They always have been the source of seed capital. Angels invest in risky businesses just like VCs, but unlike VCs they invest their own money, have a longer time horizon, and, because they generally have less money than VCs, they invest in much smaller amounts. Angels fill an incredibly important role; they provide the seed

capital to entrepreneurs to get them proved out for later venture financing. They are the first rung on the ladder. VCs really would suffer greatly if angels were not around to give rise to the companies they invest in. The vast majority, nearly 100%, of all companies take money from angels.

This activity is not so well known because individuals act on their own, often do just a few deals, and do not become “branded” the way top VC firms do; with the brand outliving generations of individual partners. But the Angel contribution is enormous.

And so this then comes to the affect of the bill being reviewed by this committee. HR 5198 would essentially lower the investment hurdle for angels to invest in startup companies. As with anything, whenever you make something more cost effective, you get more of it. The consequence of HR 5198 is simple, more angel money will flow into startups, more startups will get started, consequently more jobs will be created, and more ideas will have a chance of success or failure in the marketplace.

What is wonderful about HR 5198 is its simplicity and alignment with the way angels actually operate. Angel investing is an individual activity. The emergence of groups is still nascent and forming. Even for angels who belong to one of the well established angel groups, most investments are made by individuals on their own behalf. The tax credit is an immediate and easily understandable incentive to make these kinds of investments.

Critically, HR 5198 also does not limit the amount of money that can be invested in an entity. Rather, a limit is placed on the individual or fund investor in an annual period. Again, the limitation included in the bill mirrors the way investors act in the angel market. If a lesser incentive was proposed, little or no additional investment would occur. HR 5198 is also broad in scope in terms of the type of small businesses that are qualified investments for the tax credit. It uses SBA's size standards as a guide while excluding lifestyle and certain other businesses. Any further narrowing of the qualified small businesses would undercut the creation of many high growth, small businesses.

Ultimately, I view HR 5198 as a proposition to accredited investors that if you invest 4 dollars in a high risk start up, the government will cut your taxes by 1 dollar. Compare this 3x leverage on the government's dollar to the 0.5x leverage in the SBA's, recently suspended, SBIC program that loans money to venture capital firms (2 dollars of government money for 1 dollar of VC money). Consider also that the angel has a choice between spending his dollars on buying a second home or car or some other luxury good, or investing his dollars into a company that will in turn produce goods, hire employees, and give someone a chance to actualize their dream. Which is the incentive the committee would like to foster?

Consider, a few statistics cited by Carl Schramm, CEO of the Kauffman Foundation at the recent ACEF Angel Capital Summit in New York City, which I will paraphrase: The statistics say that a 21 year old college graduate today will be as likely to start a company in his life as it is that he or she will get married or will become a parent. Today more than

20% of people either work for an entrepreneur or as an entrepreneur in a company that is less than 5 years old. The average 30 year old will have worked for 4 employers before he is 30 (compare this to the fact that in 1960 the average American would work for 4 employers in his whole life). It is clear that small startups are an incredibly important part of the American jobs and innovation economy. Now, speaking for myself, in light of these facts, policies that enhance the creation of such small companies will have net beneficial affects in creating jobs, employment security, fostering of innovation, and maintaining American leadership in innovation.

I know angels, they are individual human beings, and they will look at the credit and realize an immediate benefit for their angel activity. Unlike alternative measures, HR 5198 does not create additional bureaucratic mechanisms. Rather, it focuses directly on the proper tax incentive needed by angel investors and funds. There will be more angel investments made if this tax credit exists. There will be more companies getting the funding they need to start, there will thus be more jobs, and, some of those companies will turn into the next Google or Apple. Which ones? We don't know. The vast majority will fail, but, if the committee wants to increase the odds for it happening, it will support and advance HR 5198.



State of Wisconsin
Department of Financial Institutions

Jim Doyle, **Governor**

Lorrie Keating Heinemann, **Secretary**

Testimony of
 Lorrie Keating Heinemann, DFI Cabinet Secretary
 U.S. House Small Business Committee
 Access to Capital for Entrepreneurs (ACE) Act of 2006 (HR 5198)
 May 10, 2006

Chairperson Manzullo, committee members, on behalf of the State of Wisconsin's Department of Financial Institutions (DFI), thank you for the opportunity to provide my testimony in support of the ACE Act of 2006.

We are all aware that small businesses create over 70% of new jobs in the U.S. and that it is important for young companies to have access to capital. I applaud your efforts in drafting this important bill, and would like to comment on our very positive experiences we have had in our state.

In 2005, the state of Wisconsin, under the leadership of Governor Jim Doyle, established a tax credit for angel investors and seed funds. Wisconsin Act 255, provides a 25% tax credit to angel investors (12.5% per year for 2 years) and seed funds (25% in year one) for their investments in "qualified new business ventures." A qualified new business venture (which is certified) is defined as an early-stage company with high growth potential that meets our Department of Commerce's eligibility criteria. A certified business can receive up to \$1 million from angel investors and individual angel investors may invest up to \$500,000 into a qualified new business venture and qualify for the tax credit.

In its first year, the tax credit package has produced significant measurable results for our state. Per NorthStar's economics report "Angel Investing Activity in Wisconsin in 2005", Act 255 has had a positive effect on angel investing and the climate for angel investing. Some of the positive effects of Act 255 include the following:

- Act 255 has drawn a useful focus on angel investing and start up companies
- Act 255 has helped to define a market for investing in emerging Wisconsin companies
- The tax credits in Act 255 help to offset some of the risk in investing in seed and early stage companies
- Act 255 has created a positive climate for investing in Wisconsin start up companies.

Of the \$3,000,000 total of angel tax credits available in 2005 (\$3 million per year for 10 years, or \$30 million is the total angel tax credit package), all of the credits were used. Per NorthStar's report: "The entire \$3,000,000 allocation of angel tax credits for 2005 has been used up as the result of over \$12,000,000 in eligible angel investment deals."

The amount of reported angel investing by organized groups increased 65% from the 2004 levels, and the number of individual angels who took advantage of the credits totaled over 290. Forty companies were funded for a total of \$19.5 million of measurable angel investments in Wisconsin in 2005. A later analysis of law firm activity (the firms voluntarily reported angel investments their clients made) to the Wisconsin Angel Network estimates that approximately \$50 million was invested by accredited investors into private businesses in our state.

Office of the Secretary

Mail: PO Box 8861 Madison, WI 53708-8861

Voice: (608) 264-7800

Fax: (608) 261-4DFI

Courier: 345 W. Washington Ave. 5th Floor Madison, WI 53703

TTY: (608) 266-8818

Internet: www.wdfi.org

To achieve these results, our state government has teamed up on a bipartisan basis with the Wisconsin Technology Council to create the Wisconsin Angel Network, an organization which provides education, networking and deal flow to the 15 organized angel networks in our state (which is up from 6 networks in 2004). I am the co-founder of the Wisconsin Angel Network and currently serve as the Chair of the Angel Advisory Committee.

As I mentioned previously, forty companies and over 290 angel investors took advantage of the tax credits in 2005. For example eMetagen Corp., a company rooted in research conducted on the UW-Madison campus, closed a \$535,000 seed investment round with Milwaukee's Marquette University Golden Angels Network. eMetagen plans to use the Golden Angels investment, along with a \$488,512 Phase I biodefense grant from the National Institutes of Health, and a \$150,000 Technology Development Fund award from the Wisconsin Department of Commerce, for the company's research and development programs. eMetagen is a drug discovery and development company founded in June 2002 to commercialize breakthrough natural product discovery technology licensed from the Wisconsin Alumni Research Foundation, better known as WARF.

eMetagen will maintain a research facility in Madison, where up to 10 jobs will be created over the next 12 months, and will establish a sales and marketing presence in New Jersey, home to potential clients in the pharmaceutical industry.

Another company, Mithridion, received a \$1.6 million angel investment round from Wisconsin Investment Partners of Madison, WI. Mithridion is in the process of establishing its lab and the University Research Park and will be hiring scientists to staff them. These high wage paying jobs will help grow our economy and raise our state's per capita income.

Both of these networks are founding members of the Wisconsin Angel Network, which is a result of Act 255.

Angel and early stage investing is helping move Wisconsin forward. By providing access to capital at the pre-seed to early stage levels and inciting angels to invest by providing the 25% tax credit, we have visibly improved the entrepreneurial community in our state.

Again, thank you again for the opportunity to testify in support of the ACE Act of 2006.

Statement to the Committee on Small Business Hearing

Bridging the Equity Gap: Examining the Access to Capital for Entrepreneurs Act of 2006
2:00 PM, Wednesday, May 10, 2006

Dan Loague
Executive Director
Capital Formation Institute, Inc.
Reston, VA
<http://www.cfi-institute.org>

The Capital Formation Institute is pleased to be a part of this hearing on this vitally important legislation. Chairman Manzullo, Rep. Pomeroy, Ranking Member Rep. Velazquez, and other members of the committee, please accept my thanks for holding this hearing today.

The "Access to Capital for Entrepreneurs Act of 2006" Act presents an exciting opportunity to greatly expand seed stage capital for start-up and growing U.S. companies. Chairman Manzullo and Rep. Pomeroy have done a great job in writing this remarkable legislation. Its provisions are a highly accurate reflection of the critical elements of private market angel and seed-stage fund investment practices. Most importantly, it targets seed capital, the single most important and continuously unfulfilled need to establish and grow start-ups.

To introduce the Capital Formation Institute (CFI), I would like to provide some background of my relationship with angel and seed-stage investors as part of CFI and previously with the National Association of Seed and Venture Funds (NASVF).

The CFI, a 501(c)(3) organization, was established in 2004 as an independent spin-off from the NASVF (<http://www.nasvf.org>). NASVF was begun in 1993 to promote information transfer among practicing parties in economic development and has now grown to be the nation's largest network of seed-stage and technology investment professionals.

CFI focuses on research and education on all aspects of early stage investment and enterprise creation, significant and critical elements of success for the nation's competitive tech-led economy. Members of CFI's governing Board of Directors are distinguished researchers and practitioners in enterprise creation and capital formation. Members of CFI's Research Advisory Board are nationally well known professionals in academia and published journals for their research in the applicable fields of study.

CFI and NASVF continue to serve expansion of resources available through angel and seed and early stage investors, a significant component of the innovation-driven economy. But because they are "under-the-radar", their importance is largely unknown. Dr. Jeffrey Sohl, Director of the Center for Venture Research, University of New Hampshire, the leading researcher in this market, reports that the total amount invested by this segment consistently exceeds or matches the total amount invested by all U.S. venture capital funds combined. In addition, they invest in tens of thousands of companies, several magnitudes higher than those invested in by VCs.

It was my privilege to be the NASVF's first executive director. Over a period of nearly 9 years with NASVF I managed and directed over 100 events including national conferences, symposia and 86 field seed investing workshops. Conferences and symposia were invitation-only, and were attended by top decision makers from government, academia and the venture capital industry. Field seed investing workshops were also invitation-only, attended by local angels, seed investment professionals and experts, plus top local entrepreneurs seeking to understand the thinking and practice of seed investors. The invitation-only aspect of these events required

extensive research for those best qualified to attend. As a result, NASVF emerged as the leading network of seed and early stage investing industry professionals.

CFI has retained the perspective of seed and early stage investment professional. However, CFI's network has a broader base of participation, including entrepreneurial development professionals and others interested in building the entrepreneurial culture in their communities.

So, when Chairman Manzullo contacted me about appearing at this hearing, I sent email messages with copies of HR5198 to several colleagues around the U.S. active in building and working with local angel groups. I asked their opinion of the likely affect in their communities of the Act's passage. All their responses were uniformly positive.

Contacted were:

1. Steve Mercil, RAIN Source Capital, Inc., St. Paul, MN
RAIN Source Capital is a multi-state network of RAIN® funds that works with angel investors who are interested in supporting growing companies.
2. Burt Chojnowski, Brain Belt Consulting, Fairfield IA
Mr. Chojnowski is a leader in the Fairfield Entrepreneurs Association and proponent of enterprise development in rural areas.
3. Orlan Johnson, Tri-State Investment Group, Research Triangle Park, NC
Mr. Johnson is the member-manager of one of the most successful angel funds in the U.S.
4. Woody Maggard, UB-STOR, Amherst, New York
CFI Board President and Associate Provost, University at Buffalo
5. Liz Marchi, Montana West Economic Development, Kalispel, MT
Ms. Marchi has recently formed a local angel group in collaboration with MinCorp and RAIN Source Capital
6. Larry Peterson, Camino Real Angels, El Paso, TX
Mr. Peterson is a leading advocate of formation of seed capital resources in Texas
7. Robert Mitchell Alpha Omega Capital Partners, Richmond VA
Managing Partner, Alpha Omega Capital Partners, Richmond and Board member, Richmond Venture Forum
8. Barry Moltz, Prairie Angels, Chicago, IL
Mr. Moltz is an active angel in the Chicago area and author of *You Need To Be Crazy: The Truth About Starting and Growing Your Own Business*

Here are some of their comments:

Steve Mercil:

The Act is written pretty well and the benefits of the Act are beyond the tax credit. It raises the importance of investing in entrepreneurs. The most likely result in communities where we work will be angel groups with 50% higher numbers of investors and 50% more dollars in angel investment pools. More importantly, raising the funds will be quicker. This speaks to the time value of money. It will help MinCorp to recruit and form new groups and the tax credit could be the last little push needed.

Burt Chojnowski:

This is fantastic. It parallels what the Iowa Capital Investment Board has done with state tax credits for accredited investors and their investment entities. This would be a real boon for angel investors and community seed fund development in rural areas...

Orlan Johnson:

It sounds similar to the North Carolina situation which I would say works. But I am biased because I participate in the credits. Unfortunately I do not have the statistics. I think CED does, that show the significant leverage generated for the state with this kind of tax credit program. I was an investor before the credit, but I would say that it has been a factor in getting people, that may not have taken the risk, into the early stage investment game. At 25% it is substantial enough to get wealthy individuals to at least look at this investment class as an option for some of their portfolio.

Woodrow Maggard:

Facilitate a stronger angel network. Buffalo has one now, but it needs to have resources added to it to help with due diligence and managing deal flow. Also, additional capital would always help.

Help us bridge deals that would flow to early stage venture capital, of which we have a number of funds to capture deals that have been deepened at the angel/seed level.

Liz Marchi:

My comments are we certainly need to be driving innovation capital in all parts of the country, especially areas that are not growing new economy business and therefore lag in wages. We obviously raised money without this but I am sure that no one would complain about the tax credit. However, I think that it is a nice extra. Our group is doing this because they believe this is a way the private sector can contribute in a needed and positive way to the local economy. Having the federal government realize that it is essential to competitiveness would be very, very nice.

Larry Peterson:

Such an act would be especially helpful for Texas, as we do not have an income tax, and have no other immediately available alternate mechanism to incenting the formation and development of Angel sources. Texas, like other states, suffers from a severe lack of early stage capital, and really only Dallas and Austin have significant later-stage venture investing.

Particularly since the non-renewal of the SBA's participating securities SBIC, this act would be a boon to poorer and flyover regions trying to develop their capital sources to give wings to their best and brightest young entrepreneurs.

Please call me if I can offer any additional assistance in this worthy effort!

Robert Mitchell:

Dan, thanks for telling me about this. I think a program like this would make a huge difference in angel investing and is greatly needed. There are few places for entrepreneurs to raise capital:

--Venture funds are large and getting larger. They're also risk averse. Companies needing funds under \$1-2 million have no where to go other than family, friends, or angels.

--Banks. Banks are terrible at backing young companies. Banks need cash flow AND collateral. They also need guarantors, which is usually the same people who are investing, namely family and friends.

Barry Moltz:

I have not read it carefully but how could this be a bad thing?

**Statement of
Luis Villalobos
Founder and Board Member, Tech Coast Angels
Managing Director, Angel-Led Venture Partners LP
Before the House Committee on Small Business**

Chairman Manzullo, Ranking Member Velázquez and Members of the Committee, I would like to thank you for the opportunity to testify. I hope to provide some insight into angel investing in small companies. I am Luis Villalobos, the founder and Board member of Tech Coast Angels, an angel group in Southern California with over 250 members, and also the Managing Director of Angel-Led Venture Partners LP, a venture capital fund that we are raising to co-invest with angel groups. I am testifying as an individual and not representing either entity.

My prepared remarks are in roughly four parts: my background to provide you context for my remarks; some observations on angel investing in small businesses that I believe may be relevant; my comments on the two bills; and some recommendations that I respectfully submit for consideration.

A. Personal Background

My entire career has been involved with small businesses. I have experience as an entrepreneur, as an angel investor, forming and running angel groups, and as a workshop leader. A biography is attached {see Luis Villalobos Biography}.

1. As an entrepreneur I started and led two ventures as CEO. Harvil Corporation which I managed became a joint venture with Hughes Aircraft Company; at the time we sold to Hughes the joint venture had two \$45 million dollar product lines. The second venture, Conographic Corporation, we sold to Gradco (a local public company) when we had around \$1 million in revenue. These companies had created more than 100 jobs by the time we sold them.

2. As an angel investor, I have invested \$3.5 million of my personal capital in 57 small companies over a period of 25 years and those investments resulted in 4 IPOs, 8 successful acquisitions and 31 of the companies remain active. I have achieved returns of 4.8x on these investments, 1.9x in realized cash, and 2.9x in residual value at current market. I currently sit on the board of Vigilistics Inc, a TCA portfolio company, and have served on boards of another dozen small companies. These 57 companies have created more than a thousand jobs.

3. I was the founder of the Tech Coast Angels, led the group for its first two years, and remain very active on its Board. In the 8 years since I started TCA and as of YE2005, TCA members had invested \$68 million of their personal capital in 108 small companies, and had attracted an additional \$656 million of external capital into those companies, mostly from VC firms; we now have over 250 members spread across four networks: San Diego, Orange County, Los Angeles, and Westlake/Santa Barbara. {See the TCA Brochure.} Tech Coast Angels is ranked by Pricewaterhouse Coopers as the #1 venture firm for entrepreneurs in Southern California, and ranked 7th nationally (tied with four other groups), even though we only invest locally – {see VC100 Reprint}. I also helped start the Camino Real Angels in El Paso Texas, and an angel group is Sydney Australia.

4. I was one of the nine founding board members of the Angel Capital Association, a trade organization for professional angel groups, which now has ~100 angel groups as members. I served on the ACA board for several years, until about a year ago.

5. I have created and conduct workshops for entrepreneurs, angel investors, angel group leaders, transaction attorneys and intellectual property attorneys, the latter two for continuing education credits, across the full spectrum of the investing process, including: valuations of small companies, due diligence, term sheets and deal structures, venture capital, angel investing, business plans, entrepreneurship, intellectual property and patents, conducting due diligence, leading angel group deals, and forming and managing angel groups. I have mentored more than a dozen CEOs of small companies.

6. I earned an SB in math from MIT, where I was a National Merit Scholar, and an MBA from Harvard Business School. My MIT education included computer science and electrical engineering, and at the beginning of my career I reviewed digital logic designs and coded the diagnostic programs for ~30 computer systems and peripherals for Digital Equipment Corporation. I have been granted 3 patents as lead inventor.

7. I was a co-founder of the Harvard Business School AOC Entrepreneurs Conference, which just hosted its 22nd annual conference {see EC2006 Brochure}, and I was the founder of the TCA Fast Pitch competition which just held its 6th annual event {see Fast Pitch Flyer}. I sit on the boards of the Paul Merage School of Business at UCI, and of the Harvard Business School AOC.

B. Five observations on angel investing and small companies

1. Success factors for early-stage investing – alignment and professional investing process

A Federal Reserve study {see Federal Reserve 1995 The Economics of the Private Equity Market} attributes the success that venture capital firms have enjoyed to a combination of “alignment” and having developed a professional investing process. Credit is also given to certain regulatory and tax changes.

Alignment. In simple terms, “alignment” is to have the investing process done by people who can only gain by helping to build successful companies. VCs are compensated by “carried interest” (a share of the profits from the investments they make, after the LPs capital is first returned); and angels are compensated by the profits from the personal capital they put at risk. Thus VCs and angels are motivated to find great investment opportunities, negotiate favorable valuation and terms, work with the ventures to help them succeed, and then help to harvest the investment through an acquisition or the occasional IPO. This is quite different than having an employee performing these activities for a salary.

Core problems. “Two types of problems frequently arise when outsiders finance the investment activity of a firm—sorting problems and incentive problems. Sorting problems arise in the course of selecting investments: Firm owners and managers typically know much more about the condition of their business than outsiders, and it is in their interest to accentuate the positive while downplaying potential difficulties. * * * Incentive problems arise in the course of the firm’s operations. Firm managers have many opportunities to take actions that benefit themselves at the expense of outside investors.” FR Study

Four-stage investing process. According to the Federal Reserve Study “The specific advantages of [VC] limited partnerships are rooted in the ways in which they address these problems. * * * [P]artnership’s investment activities are divided into four stages:

Selecting. The first is selecting investments, which includes obtaining access to high-quality deals and evaluating potential investments. This stage involves the acquisition of a large amount of information and the sorting and evaluation of the information.

Structuring. The second stage is structuring investments. ‘Investment structure’ refers to the type and number of securities issued as equity by the portfolio company and to other substantive provisions of investment agreements. These provisions affect both managerial incentives at portfolio companies and the partnership’s ability to influence a company’s operations.

Monitoring. The third stage, monitoring investments, involves active participation in the management of portfolio companies. Through membership on boards of directors and less formal channels, general partners exercise control and furnish the portfolio companies with financial, operating, networking and marketing expertise as needed.

Exiting. The fourth stage is exiting investments, which involves taking portfolio companies public or selling them privately. Because partnerships have finite lives and investors expect repayment in cash or marketable securities, an exit strategy is an integral part of the investment process.”

The changes that helped venture capital. The interpretation of the ERISA “prudent man rule” was revised to allow pension funds to invest in venture capital; private equity partnerships were redefined as business development companies, thus exempting them from the Investment Advisors Act; capital gains tax rates were reduced from 49.5% to 28% in 1978 and to 20% in 1981; and the Incentive Stock Option Law was passed in 1981.

2. High expectation entrepreneurs create jobs, innovation and economic growth

“Numerous surveys and studies emphasise (*sic*) the importance of entrepreneurial activity for job creation. These studies also show that this contribution to economic and social wellbeing is made, to a large extent, by only a small group of entrepreneurs who can be described as having ‘high-expectations.’ * * * In fact, research suggests that only a small proportion of new firms actually generate the bulk of all new jobs created by entrepreneurial firms. Approximately, 1.5% or less of the adult-age population (18-64 year olds) are involved with start-ups and recently formed businesses that expect to employ 20 or more employees in five years’ time – depending on country and world region.” {see GEM High Expectation Entrepreneurship 2005}.

The Small Business Administration generally defines small businesses as those having fewer than 500 full-time employees; there are more specific definitions – eg {see SBA Business Size Standards}. According to the SBA, small businesses total 25 million and comprise 99.7% of all businesses in the US. {see SBA FAQ from website May 6 2006}

3. There is a severe funding gap for companies in the seed, startup and early-stage

There is a widely recognized funding gap for seed, startup and early-stage ventures; eg “The work of the group confirmed that there is a fundamental market failure in the provision of early-stage financing . . .” {see Working Group On Venture Capital Final Report, US Department of Commerce}.

“Entrepreneurship and innovation are the two keys to success in economic development providing for wealth creation and a rising standard of living. Furthermore, the commercialisation (*sic*) of innovation and the growth of entrepreneurial firms require that risk capital is available, in particular at the early stages of firm growth.” Ibid.

Note that the Department of Commerce report is about venture capital – and implicit is that the seed, startup and early-stage ventures being discussed are those that have the potential for rapid growth, and what GEM calls high expectation entrepreneurs.

4. About 10 million individuals invest ~\$100 billion per year

“Informal investment is a crucial component of the entrepreneurial process. For instance, according to an analysis of Inc. magazine’s 2002 list of the fastest-growing private companies in the United States, 14 percent of the companies started with less than \$1,000, 41 percent with \$10,000 or less, and 51 percent with \$20,000 or less. Fewer than 2 percent started with venture capital.”

“Small investments primarily by the so-called 4Fs—founders, family, friends, and foolhardy strangers—are crucial in funding not only microcompanies but also future superstars. In comparison, formal venture capital is very rare at the seed stage of a new venture. For example, several million Americans are nascent entrepreneurs attempting to start new ventures. However, in a typical year, only a few hundred of them have formal venture capital in hand when they launch their businesses. In every nation except Israel, the amount of informal investment handily exceeded the amount of classic venture capital. For all the GEM nations, informal investment was 89 percent of informal and classic venture capital combined; for the United States, it was 72 percent. Not only is informal investment by far the largest source of financing for seed-stage companies, it is also widespread throughout the population. In 2002, 4.6 percent of U.S. adults were informal investors, which was the highest rate among the G7 nations. Most informal investments are small, with the 50th percentile at \$1,667 annually. But some investors invest large sums, with the 99th percentile at \$255,000 (Table 6). While informal investors are abundant in all age groups, the older investors are more likely to invest larger amounts. Approximately 50 percent of informal investments are made in companies owned by relatives; only 7 percent of investments go to strangers.” { see GEM 2002 Executive Report }.

TABLE 6 INFORMAL INVESTMENT U.S. 2002— AVERAGE INVESTED PER YEAR	
25th Percentile	\$300
50th Percentile	\$1,667
75th Percentile	\$5,000
90th Percentile	\$20,000
95th Percentile	\$40,500
99th Percentile	\$255,000

The data on informal investors in the table below was derived from the above data and from several conversations Bill Bygrave, the lead on GEM.

Invested Total in \$xB	Invested at least	Invested up to	Individuals
8	100	5,000	7,500,000
12	5,000	20,000	1,500,000
15	20,000	40,500	500,000
25	40,500	255,000	400,000
40	255,000		100,000
100			10,000,000

5. The emergence of professional angel groups provides a great opportunity

In 1994, Hans Severiens started the Band of Angels (the “Band”) in Silicon Valley, and created the modern-day angel group. In late 1997, Luis Villalobos started the Tech Coast Angels (“TCA”) in Southern California. He based TCA on the Band model, and enhanced the investing process, including workshops for members, normative forms, electronic support and portfolio tracking database and reports.

The larger groups have formal investment processes that equal or surpass the proven VC fund investing model. In most angel groups, members meet regularly and closely collaborate in screening deal flow, performing due diligence, negotiating VC-like investment terms and structures, and closely support the ventures they fund. Most groups make individual investment decisions (ie each member decides whether or not to participate in a given deal, and in what amount, but under the same valuation and terms); but some groups pool their capital and invest as a group. In all cases, the angel members take an active role in the investing process, both pre- and post-funding.

The larger groups, like the Tech Coast Angels, have adapted the proven 4-stage VC investing process, and have greatly expanded the due diligence stage to include retooling the venture’s business plan – {see Tech Coast Angels Funding Process}. TCA members often spend 300-500 member-hours working with a venture before funding them; 10%-15% of these hours might be traditional due diligence (verifying market size, customers, references, backgrounds, etc) with the remainder devoted to retooling the business plan (narrowing the product offering, focusing on fewer markets and distribution channels, optimizing the use of capital with multi-stage funding, prioritizing operations, etc). A VC fund would find it difficult to justify devoting 500 hours of GP time before investing in a venture; especially at early-stage, when the venture can only profitably absorb \$1 million or less in capital. It is almost impossible for individual angels, who may be individually investing \$25,000 or \$50,000, to undertake this level of investment process.

The greatest strengths of angels groups are their numbers and the operating experience and expertise of their members. The average group size of the 94 member groups of the Angel Capital Association is 44 angels per group; these angels typically have experience as CEOs, starting ventures, and running small and large companies.

Angel Capital Association. ACA is a trade organization for professional angel groups. There were nine founding board members of ACA, including Susan Preston, Ian Sobieski and Luis Villalobos, three of the witnesses at this hearing. At its annual meeting in April 2006, ACA reported that 94 angel groups having a total of 4,100 angels were members of ACA (for an average group size of 44 angels); and that the 50 groups that reported investment data had invested an average of \$1.45 million per group – which would mean that those 50 groups collectively invested \$72.5 million in 2005. One of the ACA charts showed a total of 250 angel groups as of year end 2005. Note that 4 or 5 of the ACA groups are non-US (Canadian). {see State of ACEF-ACA April 27 2006}

C. Comments on the H. R. 5198 and H. R. 4565 Bills

Let me begin by saying that I can support both bills. That said, if a choice had to be made between the tax credit provisions of the two bills, I would favor the tax credit of H. R. 4565, primarily for two reasons.

First, H. R. 4565 more narrowly targets small businesses by limiting the credit to investments in companies with fewer than 75 employees; whereas the credit of H. R. 5198 applies to

investments in qualified small businesses, which generally raises the size to those with fewer than 500 employees. I would prefer to have both bills target much smaller companies and to focus or at least favor what GEM calls high expectation entrepreneurs; ie seed, startup and very early-stage ventures that have high potential to create 20 to 50 or more jobs within 5 years.

A second reason is that H. R. 5198 credits are based on making investments in small businesses, which is good – anything that brings more investment capital to small businesses is something I highly favor. But in my opinion H. R. 4565 is better in that its credits are based on profits from investments in small businesses, and thus puts the additional capital (from the credits) in the hands of presumptively successful investors – which one might expect to lead to better capital efficiency as that credit capital is hopefully reinvested. Some provisions should be added so that the credits on investment gains are not just windfalls – eg have the credits apply either to investments made after the date of the bill, or when the taxpayer has made a qualifying investment in that tax year that is at least as great as the gain that serves as the basis for the tax credit.

I strongly support the Sec. 381 Angel Finance Program that provides financing to angel groups that meet certain standards and I applaud the provision that recycles the profits back to the Angel Investment Fund. I have worked extensively in the past decade to bring professional investing processes to angel groups and I am convinced that a professional angel group is a far better model for investing in early-stage high-growth companies than either individual angels or VC funds. I would however, suggest several modifications: (a) change the number of members an angel group must have to qualify, from 2 to 25 – the larger size is essential for a robust investing process, both to have a diversity of expertise and experience and to be able to devote sufficient time to screening companies (Tech Coast Angel members often spend 500 member hours working with a company before funding them), and to have the broad networks that are so useful in supporting companies post-funding; (b) change the size definition of the small companies that qualify for such investments from fewer than 75 employees to those that would meet what GEM describes as “high expectation entrepreneurs” (one of those expectations is to grow their company to at least 20 employees within 5 years) – companies that have 20 or more employees are almost invariably producing revenues (say \$2 million if they have \$100,000 revenue per employee) and beyond the funding gap, so they can fairly readily access venture capital or other forms of financing; (c) clarify what happens when there is a partial recovery of capital – ie no profit from the investment – whether the recaptured capital is intended to be returned to the Angel Investment Fund, or to offset some of the losses of the angel group investors and even change their position from loss to gain (eg if an investment with matching amounts from the Angel Investment Fund and a qualifying angel group, loses 60% of the invested capital, there is no gain, but the 40% of recaptured capital, if retained in the angel group, would cut their losses from 60% to 30%, and increase the losses of the Angel Investment Fund to 100%); and (d) clarify the criteria for qualifying angel groups to include those groups (most of them) that invest as individuals but under common terms and valuation, and to define what would be considered an angel group deal (eg investment of \$200K or more from with at least 5 members participating in the financing).

I fully support the Sec. 383 Grant Program for Development of Angel Groups and also the establishment of Sec. 380 Office of Angel Investment.

The Sec. 382 Federal Angel Network may need restructuring to put an intermediary between the individual angel investors and the entrepreneurs – I believe that ACE-Net (a similar matching network that was created by the SBA in 1996) has shown that a direct match between entrepreneurs and individual angels is not that effective – the entrepreneurs end up needing to

aggregate 10-20 angels from across the country, who may never have met, in order to raise their funding; and disparate individual angels across the country have difficulty with the investment process (eg sharing due diligence) or agreeing on financing terms (as various of them may have different ideas on valuation and the type of security to be issued). The Department of Commerce Final Report on Venture Capital recommends combining angel investors with classical venture capital. The “angel-led” model {see Angel-Led Venture Partners} is an example that could work for the Federal Angel Network – ie where the entrepreneurs must entice a qualifying angel group, who then posts the deal on the Network for additional investment by individuals angels on the Network – some work has already been done with ACE-Net and the “angel-led” model.

D. Five Recommendations

First, focus on filling the funding gap for what GEM calls “high expectation entrepreneurs” – the companies that create jobs and economic growth. Once a company gets past the funding gap – typically scales to 20 or more employees, or attains annual revenues of \$2 million or more – then the company has reasonable access to VC funding or other type of financing.

Second, focus on those investors who meet the success profile: are active in the investment process, both pre and post funding; who have a professional investing processes; and who have broad networks.

Third, provide support for existing professional angel groups and to develop new ones. A professional investment process almost requires some aggregation of individuals, whether in an angel group or as managers of a VC fund, especially to conduct due diligence and to have a broad network to support the company post funding. According to GEM data there may be 2.5 million accredited informal investors, but there are only ~10,000 individuals in angel groups.

Fourth, support what the Department of Commerce report recommended – combining the activities of angels, who are active in seed and early stage investing, with mainstream venture capital, through co-investment models. Consider an “angel-led” model; eg {see Angel-Led Venture Partners}.

Finally, collect statistics on the ~10 million individuals that GEM calls “informal investors” and on angel investors. How much do they invest in total per year and per company, the companies they fund, the returns on their investments, and the performance of the companies they fund. There is no definition that is generally accepted for “angel investor” – there is general agreement that an “angel investor” is: (a) an individual; (b) who makes direct investments in companies. But there is no consensus as to whether the definition of an “angel” would include: (a) individuals who are completely passive investors (as opposed to being active in some part of the investing process in at least some of their investments); (b) whether the individual has to be an accredited investor or not; (b) how much an individual needs to invest to qualify as an angel, eg is Bill Gates making a multi-billion investment in a satellite company an angel investor? Or is someone who invests \$1,000 in his neighbor’s corner grocery store an angel? Does a single investment qualify an individual as an “angel” – or must there be some pattern of such investments? Is an investment made into a family venture an angel investment? Or is an investment made into a small company that is run by the investor considered an angel investment?

(Closing)

I am grateful to this Committee for holding this hearing and for the opportunity to testify. I welcome your questions. Thank you.

Executive Summary

Key Findings

High-expectation entrepreneurial activity represents only a small proportion of all entrepreneurial activity, yet it explains the bulk of expected new jobs by cohorts of nascent entrepreneurs and baby businesses. Depending on country and world region, only some 3% to 17% of nascent entrepreneurs and baby businesses expect to employ 20 or more employees within five years. Only some 1 % to 7 % of nascent entrepreneurs and baby businesses expect to employ 50 or more employees within five years. However, its economic potential is significant, as high-expectation entrepreneurs are responsible for up to 80% of total expected jobs by all entrepreneurs.

The rate of high-expectation entrepreneurial activity varies significantly among world regions and individual countries. The highest adult-age population-level participation rate in high-expectation entrepreneurial activity is observed for North America (Canada and USA), Anglo-Saxon countries¹ (Australia, Ireland, New Zealand, United Kingdom, and USA), and Oceania (Australia and New Zealand). For these regions, the population-level prevalence rate of high-expectation entrepreneurial activity ranges from approximately 1% to 1.6%. The lowest adult participation rate in high-expectation activity is observed for European and highly developed Asian countries (Hong Kong, Korea, Japan, and Singapore), where this rate is approximately 0.5%. In Spain, adult-age participation in high-expectation entrepreneurial activity (20+ expected jobs) is only approximately 0.2%.

The prevalence rate of high-expectation entrepreneurial activity in Europe and highly developed Asia is worryingly low. There are no differences between European country groups (large EU countries, small European countries, new EU member countries), even though differences can be observed between individual countries. Spain, in particular, stands out because of its low participation rate in high-expectation entrepreneurial activity.

High household income, high education level, and opportunity motivation are most strongly associated with high-growth expectations. The greatest distinguishing elements for high-expectation entrepreneurial activity are observed for income, education, and opportunity motivation. These are suggestive of the individual-level economic trade-offs related to the entrepreneurial decision.

Population cells differ significantly in terms of high-expectation entrepreneurial activity. The highest prevalence observed for a single population cell (a 'population cell' refers to a sub-group of the general

population, defined using one or several demographic characteristics such as age category, gender, and education level) is ten times higher than the population-wide participation rate in high-expectation entrepreneurial activity. Of baby business managers, 25-34 year old, high-income and well educated males displayed a 4.4% participation rate in high-expectation activity – meaning that nearly one in twenty individuals in this population cell are actively engaged with high-expectation entrepreneurial start-ups.

The relative prevalence of high-expectation activity appears positively associated with national entrepreneurial framework conditions. The correlation analysis suggests that the anatomy of entrepreneurial activity is more strongly associated with national conditions than is the overall prevalence of high-expectation activity. This may be associated with differential opportunities for entrepreneurship in high- and low-income economies.

Active policy has a role to play in promoting high-expectation entrepreneurial activity. Even though direct causal inferences are not possible from the present analysis, the evidence of differential relationships with national conditions for different forms of entrepreneurial activity suggests that there is room for active entrepreneurship policy interventions.

Governments should be aware of the importance of high-expectation and high-potential entrepreneurial activity and consider introducing highly selective support measures and policies. To the extent to which the goal of government policy is to support job creation through entrepreneurial activity, governments should be aware of the highly skewed distribution of job creation expectations within populations of nascent and baby businesses. They should study who is behind high-potential entrepreneurial activity, and how this kind of activity could be supported. Given the skewness of the distributions reported here, highly selective policy measures could prove more effective for job creation purposes than non-selective ones.

¹ We use the term 'Anglo-Saxon' to refer to English-speaking countries that have a strong 'Anglo-Saxon' tradition in terms of how their financial market institutions are structured.

Testimony in Support of the Access to Capital for Entrepreneurs Act of 2006 (HR 5198)

Jeffrey E. Sohl, Ph.D.
Professor of Entrepreneurship and Decision Sciences
Director, Center for Venture Research
Whittmore School of Business and Economics
University of New Hampshire

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The following comments and observations on the angel market are based on over fifteen years of research that I have conducted as a Professor and Director of the Center for Venture Research (CVR). The CVR is the only independent source of reliable statistics on the angel market in the United States. The CVR has been conducting research on the angel market since 1984. The CVR's mission is to provide an understanding of the angel market and the critical role of angels in the early stage equity financing of high growth entrepreneurial ventures. Through the tenet of academic research in an applied area of study, the CVR is dedicated to providing reliable and timely information on the angel market to entrepreneurs, private investors and public policymakers.

In 1874, a young Alexander Graham Bell was searching for money to complete his early experiments on the telephone. Most investors adopted the prevailing opinion as summarized in an editorial in the Boston Post “well-informed people know it is impossible to transmit the voice over wires and that were it possible to do so, the thing would be of no practical value.” Besides, Mr. Bell did not have a company with any tangible assets to provide collateral. Recognizing an opportunity, Boston attorney Gardiner Green Hubbard and leather merchant Thomas Sanders of Salem, Massachusetts put up the equity capital to start the Bell Telephone Company of Boston (Sohl, 2003). The rest is history. Fast forward 100 years to witness perhaps one of the most lucrative angel deals, when in 1976 Anita Roddich needed capital to open a second store. Her bank responded that she had only been in business a few months, she had no track record and that she should wait another year. Ms. Roddich turned to a private investor, Ian McGlinn, who invested the 4000 pounds sterling she needed. She opened that second store and so began the development of the Body Shop, a corporation with over 700 stores today. From telephones to cosmetic stores, the angels progressed into the internet when in 1994 Jeff Bezos and a few employees created a web site and database in Bezos’ Bellevue, Washington garage. He went looking for capital from venture capital firms but their response became a familiar one: good idea but, well, maybe later. After being introduced to some private investors, he succeeded in raising \$1.2 million from a dozen private investors. A later round of \$8 million was provided from professional venture capital funds. In May, 1997 the company, Amazon.com, completed an initial public offering, providing the investors and entrepreneurs with a handsome return (Sohl, 1999).

These humble beginnings of the angel market provided the motivation for research on the early stage equity financing of entrepreneurial ventures. Beginning in 1984, with the seminal work on business angels conducted by William Wetzel (1983), the Center for Venture Research has been collecting and analyzing data on the angel market. Although angel investors have been in existence for many years, they are in many ways our nation’s least understood, and most underutilized, economic resource. Quietly providing the majority of the seed and start-up capital for high tech entrepreneurial ventures, the angel market of today faces some significant challenges. The angel market is in constant flux, and the recent volatility of the private equity market has only provided additional motivation to understand the role of these critical early stage investors and to facilitate their investment activity.

The entrepreneurial economy and its contribution to economic growth and job creation in the United States has been well noted in both the academic literature and by various government agencies. High growth entrepreneurial ventures hold the greatest potential for innovation, commercialization of technology and sustainable economic development. However, entrepreneurial ventures face significant financial hurdles in the early stage of their development (Sohl, forthcoming; Amatucci and Sohl, forthcoming). Unable to attract debt capital in the early stage, and the mismatch between the need for growth capital and the short term financial requirements of debt financing, contributes to the importance of equity financing. This critical role of early stage equity financing throughout the history of the entrepreneurial economy has been well documented (Wetzel 1986, Ou 1987, Gaston and Bell 1988, Mason and Harrison 1992).

Angels (private investors) are the oldest and largest source of seed and start-up capital for entrepreneurs. In the United States angels invest more dollars in more companies than the formal, or institutional, venture capital market. In 2005, in the United States, angels invested \$23.1 billion in 49,500 ventures, or approximately \$470,000 per deal (Center for Venture Research 2005). In contrast, during this same time period venture capital funds invested \$22.1 billion in 3,008 deals, for an average of \$7.4 million per deal. In the seed and start-up stage, the difference between angels and venture capitalists is even more stark. Close to 55% of angel deals in 2005 were in the seed and start-up stage, while venture capitalists allocated a mere 6% of the deals to these stages. Even during the best of times venture capitalists, over the last decade, have never invested more than 15% of the deals in the seed and start-up stage. As such, angels and venture capitalists occupy unique spaces in the spectrum of providers of risk capital. Angels invest smaller amounts per investment and are the seed engine for entrepreneurs, while venture capitalists invest in larger deals in the later stages of growth. The majority of these angel deals are in the critical seed and start-up stage.

In spite of the volume of angel investing, the early stage equity market is fraught with inefficiencies. For the firm with an established financial record and tangible assets, financial markets supply an extensive assortment of financing instruments, with these markets being relatively accessible and the owner is left to decide the optimum mix of a financial structure based on the cost of capital. For the high growth entrepreneurial firm, this supply assumption may not hold, causing systematic market mismatches at particular stages of development of the fast growth firm (Brophy 1997). These imperfections, most notably in the informal venture capital market, are well documented (Freear, Sohl and Wetzel 1994a; Harrison and Mason 1993; Landstrom 1993; Mason and Harrison 1992; Gaston 1989; Riding and Short 1987). Market imperfections lead to market inefficiencies. While the need for early stage angel capital exists, inefficiencies in the private equity market are manifested by two substantial capital gaps: a primary seed stage gap and a secondary post-seed gap (Sohl 2003).

The primary seed stage gap is a capital and information gap between the needs of early stage ventures and the suppliers of early stage capital, in part due to an inadequate supply of patient, high-risk value-added equity capital (Sohl and Wetzel 1996). Information inadequacies are the byproduct of the inherent inefficiency of the angel market. An efficient market implies an open and timely flow of reliable information concerning financing sources and investment opportunities. In the informal venture capital market, with the suppliers of capital seeking a degree of anonymity consistent with the need to maintain reasonable deal flow, information flows very inefficiently (Freear, Sohl and Wetzel 1994b; Mason and Harrison 1996). This capital and information inefficiency results in the primary seed stage gap. This primary funding gap occurs in the seed and start-up financing stage and ranges from \$100,000 to \$2 million. While this is the main area in which angels operate, both the difficulty in finding angels and the lack of “investor ready” quality deals, combined with an inadequate supply of capital, results in a substantial funding gap.

The second funding gap, the secondary post-seed gap, occurs in the \$2 to \$5 million range (Sohl, 1999). These larger capital requirements have traditionally been considered too large for angel investors and, as the venture capital industry migrates to later stage and larger deal size, are deemed too small for venture capitalists. Recent research indicates that angels are increasing their investments in this \$2 to \$5 million range as market conditions require angels to provide some follow-on financing for their investments (Center for Venture Research 2004, 2005). However, this movement by angels to second stage financing is a redistribution of risk capital and as such, exacerbates the capital gap in the seed and start-up stage.

It is in this critical seed stage funding gap where tax incentives can be most effective. Seed and start-up stage investors face substantial risk due to the uncertainty of concept development into a commercially feasible product, the uncertainty of market acceptance, the scalability of the venture, information asymmetries and the inefficiency inherent in seed and start-up stage investing. A tax credit at the time of the seed investment provides the entrepreneur with capital exactly when it is needed, during product and firm development. In addition, the Access to Capital for Entrepreneurs Act of 2006 affords the angel investor with a degree of downside risk protection and the tax credit could well transform the risk/reward equation into one with an acceptable level of investment and return that is commensurate with the risk of early stage equity investing. It should be noted that previous research conducted by Jeffrey E. Sohl and the Center for Venture Research indicates that a reduction in the capital gains tax (a tax savings realization at the time of exit) appears to not be a favorable tax incentive. In essence, the venture needs to survive the critical seed stage and expand into a viable business with reasonable market share before an exit (merger, acquisition or initial public offering) can take place. As such, a capital gains reduction, which occurs at the exit event, is only realized if the venture survives the seed stage. Thus, the proper tax incentive program is one that is targeted at the "front end" during the start-up stage, when the risk of failure is the greatest and the capital gap is the most severe. The tax credit proposed in HR 5198 is a judicious use of public policy since it targets the incentive at exactly the time it is needed by both the entrepreneur and the angel investor. For the entrepreneur HR 5198 increases the potential for securing seed capital and for the investor the act indirectly provides a slight reduction in the risk of seed stage investing. For the entrepreneurial economy HR 5198 mitigates, in part, the primary seed stage capital gap. While HR 1598 will not solve all the difficulties facing the entrepreneur in securing critical seed stage equity capital, I applaud the efforts of Representatives Manzullo and Pomeroy for this important first step in facilitating the growth of the entrepreneurial economy and increasing the potential to move innovation from the laboratory to the marketplace.

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